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Regulation

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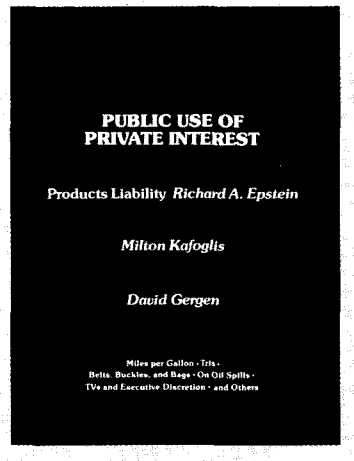

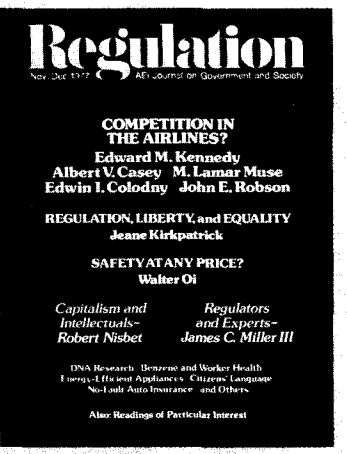

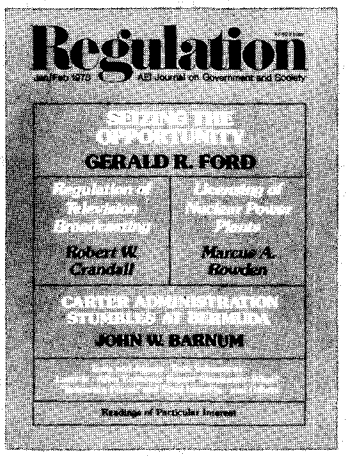

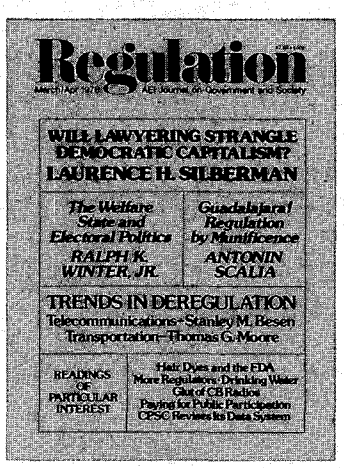
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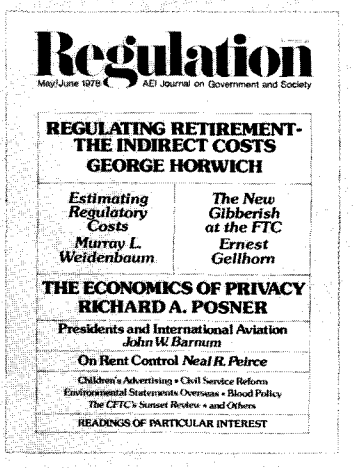
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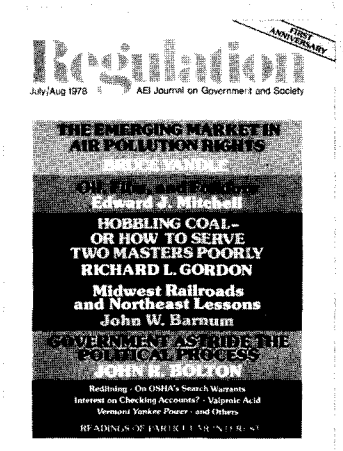
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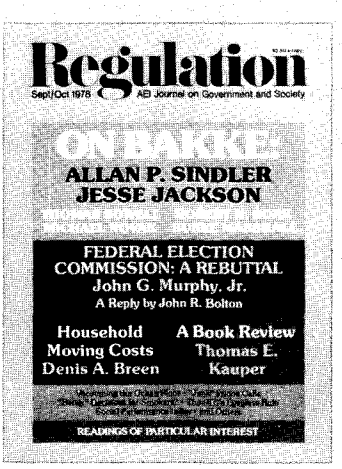

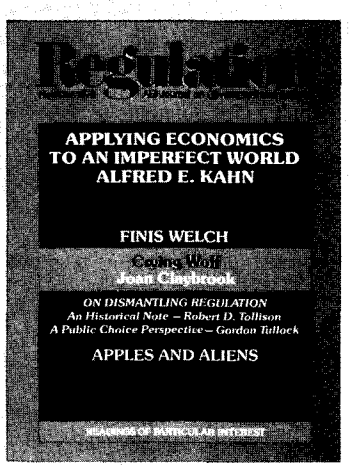

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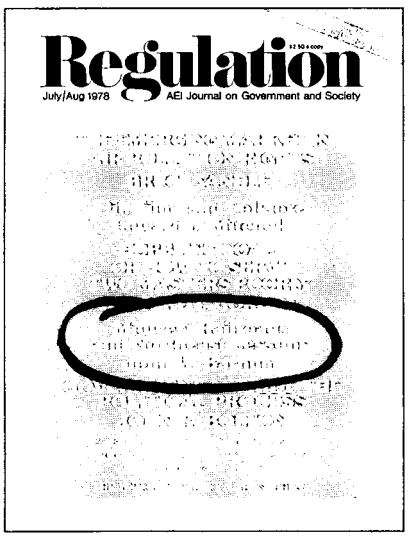
Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.



More Railroad Lessons

TO THE EDITOR:

In "Midwest Railroads and Northeast Lessons" (*Regulation*, July/August 1978), John Barnum thoughtfully articulates some of the important considerations emanating from the reorganization of Penn Central et al. But clearly he has biased his argument in favor of the "controlled liquidation" theory—a reorganization technique which died on the vine in the Northeast and will, in my judgment, just as surely fail in the Midwest.

In the beginning of the Penn Central reorganization process, three different theories were vying for acceptance. The Department of Transportation, largely through the persuasive voice of Mr. Barnum, argued for "controlled liquidation" —the piecemeal absorption of the bankrupt system by surrounding solvent roads. Other forces, especially in New England, pushed hard for "nationalization" — a concept meaning different things to different people, but, at a minimum, consisting of federal government ownership of the roadbed. The United States Railway Association, the primary planning body, favored a "mixed" approach where a new "private enterprise" (but publicly funded) organization would take over operation and ownership.

Both the controlled liquidation and federalization theories collapsed of their own weight. The former collapsed because the solvent railroads—no fools when it came to discerning their own self-interest—respectfully declined the government's offer to take over thousands of miles of track for the sole privilege of losing money. The latter collapsed because it would cost too much and because it smacked of socialism.

The result was Conrail, a compromise solution and surely far from perfect. But at least it kept the trains moving; it allowed competing interests to partially satisfy most of their objectives; it permitted federal funds to be applied toward badly needed track rehabilitation; and it accomplished some rationalization of the rail structure. Conrail will almost certainly continue to be highly unprofitable in the near future. But this does not mean that the planning process which created it was unsuccessful or that a similar process would be inappropriate for the Midwest.

Mr. Barnum argues that the Midwest is "different." Controlled liquidation, he maintains, will work there because "there is enough local and bridge traffic . . . to make railroading *profitable for a system burdened by less duplication*" (emphasis mine).

Ah, there is the rub. Is it really plausible to believe that Congress, labor, shippers, and communities will stand idly by while solvent carriers pick and choose the routes and trackage that will most please their stockholders? Even assuming they would, is it plausible to believe that the solvent railroads could ever agree how to slice up the pie? Most railroads would rather undergo Chinese water torture than concede the slightest competitive advantage to another carrier. The Rock Island–Union Pacific merger was held up eleven years while competing railroads bickered before the ICC. . . .

Mr. Barnum suggests that this problem might be eliminated by providing government "incentives" (read "money") for private sector restructuring. But is it realistic to believe that Congress will throw federal funds at the private carriers without demanding a voice in the way lines will be rehabilitated, in the routes retained, and in the service provided to shippers. . . ? Mr. Barnum's paean to private sector restructuring comes within a whisker of being naive.

Collister Johnson, Jr.,
Peabody, Rivlin, Lambert & Meyers

TO THE EDITOR:

. . . . There can be no quarrel with the general premise of John Barnum's article—that the railroad situation in the Midwest is different from the situation which brought about Conrail. While predictions are risky, it does seem unlikely that any serious attempt for a Midwest Conrail will be forthcoming. As of today, the Midwest problem seems to be working itself out along more traditional lines of reorganization, consolidation and abandonment.

I can take no exception with Mr. Barnum's six lessons, but I would add an additional lesson that many of us are learning: Conrail may not be the solution to the rail problem even in the Northeast states. Income has been consistently lower than projected in the Final System Plan and expenses consistently higher. To the extent that Mr. Barnum and the Ford administration insisted on including a continuing reorganization concept in the 4-R Act (which permits supplemental sales of parts of Conrail), the requisite flexibility is available to change the size and character of Conrail radically in the years to come. If such a reshuffle in fact takes place, the primary lesson we may have learned from the Northeast is the necessity of keeping legislative structures flexible enough to adapt to marketplace realities.

J. Paul Molloy,
House Committee on Interstate and Foreign Commerce

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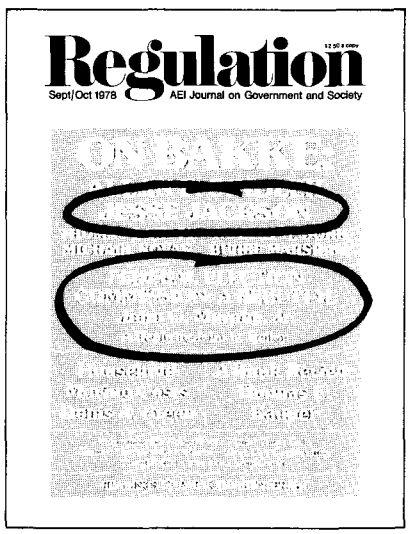
JOHN BARNUM responds:

Mr. Johnson is quite realistic in his assessment of the political implications of a "controlled liquidation" solution in the Midwest. I would also suggest, however, that as the price tag for government-designated reorganization in the Northeast rises and as taxpayers everywhere evidence their concern for ineffectual government spending, the low-cost/high-payoff solution in the Midwest will have added attraction—even to Congress.

I should also point out that I was not (as Mr. Johnson asserts) the advocate of "controlled liquidation" in the Northeast, but rather the proponent if not the progenitor of the concept of a collective reorganization. Certainly that was the thrust of the secretary of transportation's report to Congress and of the Regional Rail Reorganization Act of 1973. In the subsequent deliberations at the U.S. Railway Association, I was not advocating "controlled liquidation" but rather what some of the staff called "Barnum's Railroad," also described as "Conrail 1/4." Talk about my being naive! But I think Conrail 1/4 is only a matter of time; there just is not enough money for the present plant.

I accept Mr. Molloy's amendment.



Campaign Regulation

TO THE EDITOR:

John Murphy's article ("Federal Election Commission: A Rebuttal," September/October 1978), rather than being a rebuttal of John Bolton's attack on the FEC, serves to confirm Bolton's major points.

Bolton's major criticism of the Federal Election Campaign Act ("Government Astride the Political Process," July/August 1978) and the operation of the FEC is that both tend to limit freedom of speech, and—somewhat surprisingly for a rebuttal—Murphy agrees! For example, in commenting on the TRIM issue, Murphy wrote: "I am now all but convinced that the agency's current approach to the Sierra Club and TRIM questions will be rejected by the courts: The First Amendment value of protecting issue discussion (short of express advocacy) will simply prove too strong." Yet, according to Murphy, if the court does protect this free speech, "fortunes can be spent frankly and avowedly to influence the federal electoral process and the public will never learn the source or authorization of the first dime." Thus the law will either suppress free speech or be ineffective in achieving its primary purpose.

Murphy's comment on the FEC's decision regarding the funding of the presidential debates is also revealing: "it was unthinkable that the election laws could somehow get in the way of an event of such politically historic (even festive) proportions." And although Murphy characterized the case as "rare" and "difficult," he does not doubt its importance. Bolton questioned whether the FEC should make important and difficult arbitrary decisions which can have a major impact on politics.

The commission's handling of the Koch-Mitchell decisions is another key point in Bolton's view. Murphy acknowledges that the FEC did not explain its Koch-Mitchell decisions clearly, and yet he believes that anyone who paid even minuscule attention to FEC affairs should know "precisely where the difficulty lay." But I would ask, *why* should those who pay little attention to the day-to-day decisions of the FEC, especially on a matter that did not directly affect them at the time of its consideration, be able to understand what the FEC and its lawyers were unable to explain adequately to the parties in question?

Murphy's reference to those who seek to influence federal elections as "consumers of this difficult law" strongly suggests that he perceives a continuing relationship between the regulators and the regulated, whereas Bolton is concerned about political drop-outs or potential "consumers" for whom once is enough. The consumer analogy may represent the way an FEC lawyer sees things, but it is clearly not the view of the regulated.

Bolton's arguments are strong, even though he has not yet fully proven his case. On the other hand, while there may be justification for the FEC and even for the current law, Murphy's rebuttal is less than persuasive.

Richard G. Smolka,
Washington, D.C.

TO THE EDITOR:

Any act of government impinging on individual liberty warrants intensive scrutiny. . . . Mr. Bolton's conclusions follow a long acquaintance with the act and at least passing attention to the FEC's work. They are a hopeful start but a long way from a responsible treatment of the subject. . . .

For instance, Mr. Bolton in his original article says that nowhere in the enforcement procedures is there reasonable opportunity for a respondent to demonstrate that no action should be taken. In his rejoinder to Murphy's contrary evidence, that in the great majority of complaints the respondent was able to demonstrate that no action was warranted, Bolton says: "If, in fact, the vast bulk of enforcement actions are dismissed without fines or other sanctions, then it seems apparent that something is wrong with the way compliance actions are brought and handled."

This example illustrates deeper shortcomings in Mr. Bolton's approach. He seems unaware of the realities of politics and how the act and the commission are designed to deal with them. . . . The FEC has stressed the need to inform and educate political participants, not to drive them out of politics. The very fact that Congress in its 1976 amendments to the act changed most criminal provisions to civil penalties reflected an effort to give proper weight to minor kinds of violations. Mr. Murphy's article makes the point that the commission has met this responsibility well.

Another example is his comment about the role of business and labor in the political process. "Not only are business and labor not under new restrictions," he says, "but the statute has provided more opportunities than ever before for them to exercise political influence." Where has Mr. Bolton been all these years? Prior to 1976, prior to 1974, labor was active in the ways permitted in the statute and its powers have not

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been increased, though some doubts about borderline illegalities have been resolved. Business always has had the powers it is now beginning to exercise—parallel to labor—but it entertained some uncertainties and regrettably chose to utilize other channels to put money into politics. In fact, the act places new restraints upon business and labor and all other special interests; for instance, in 1976 contributions to all political committees were limited for the first time. One of the great contributions to the political process, worked out with great care by Congress in 1976, is that special interests are now visible, are well-balanced, and are limited.

One final point about Mr. Bolton's comments. They are a lawyer's brief, listing the strong points of his complaint, the weak points of his opponent's. This is perfectly proper for a courtroom argument but not particularly useful in this kind of dialogue. He totally misses the mark when he reaches for his big conclusion: "the impossibility of fair and equitable regulation of campaign financing under *any* statute as administered by *any* commission" (his emphasis).

Can anyone decide what is fair and equitable regulation for campaign financing without comparing it with the prior practices and evils of politics?

Mr. Bolton says there is a workable solution: "Rather than attempt to limit, to proscribe, or to regulate politics, we should restrict the federal presence in the area to properly drawn disclosure statutes. . . . it would free the political process from the threat of haphazard enforcement and discretionary rulemaking. . . ." Has he considered what this would entail? How in the diverse and changing political practices of the fifty states — where many permit corporate and labor union contributions, cash (anonymous) contributions, "loans," and contributions in kind — would he suggest that presidential elections be conducted and fully disclosed?... Is he unworried by escalating campaign costs . . . ? Finally, how does even a properly drawn statute get enforced?

Mr. Bolton, Mr. Murphy, and I agree that disclosure is the heart of an honest and credible political system. But disclosure is not enough. As the Supreme Court said in upholding contribution limits in *Buckley* v. *Valeo*, such measures enacted gradually by Congress over the years are justified and reasonable. I think Mr. Murphy's article helps to show that the Federal Election Commission's enforcement of this new law has been reasonable and moderate and will help, not hurt, the political process.

Neil Staebler,
Commissioner,
Federal Election Commission

JOHN BOLTON responds:

Commissioner Staebler's basic point is that the FEC's enforcement of the campaign finance laws "has been reasonable and moderate." The most persuasive rebuttal to that contention has already been made by the commission's own lawyers, in a brief filed on the commission's behalf in *Socialist Workers 1974 National Campaign Committee* v. *Jennings*, a case now pending in federal district court in the District of Columbia.

The commission's brief contrasts the status of the FEC with that of Article III courts, where judges have lifetime tenure and are removable only by impeachment: "By comparison, the Federal Election Commission does not possess the same insulation from political pressures, which can give rise to the appearance of politically influenced decisions." The brief goes on to say that the FEC is purely "an investigatory and enforcement body" and that "[t]his statutorily ordained role necessarily gives an administrative agency a narrow and restricted viewpoint."

In the most graphic passage of all, the commission's brief once again contrasts the FEC with the courts: "Courts, on the other hand, do not suffer from this purposely induced congenital myopia." It goes without saying that any agency that feels that way about itself is going to be hard pressed to provide "reasonable and moderate" enforcement of a statute.

Bakke

TO THE EDITOR:

Mr. Jesse Jackson's "Reparations Are Justified for Blacks" (September/October 1978) fairly reeks of the loose thinking that so permeates the issue of affirmative action.

First, he recurrently invokes concepts such as "justice," "equality," "parity," and "equity" without once specifying whether he means these terms to refer to groups or to individuals. It is of the utmost importance to be explicit about this choice, since the two approaches imply social reforms that have opposite effects on individuals. One approach focuses on equilibrating the group ratios and treats individuals so as to get the group ratios to come out "right," while the other seeks to be fair to individuals and lets the group ratios be the *outcome* of such individually fair treatment. . . . We may infer from Mr. Jackson's context that he intends these terms to pertain to groups, but this is a far-reaching alteration of their common usage, and such a crucial matter ought not go unargued. . . .

Second, he pretty much sails past the central question of "special admissions" for minorities—namely, can these admittees do the work? Merit criteria, after all, are not merely a rationale for passing out social favors but rather a means to identify those most able to achieve competency in their professions. It is of course legitimate to ask whether these criteria are at present giving false readings of the true academic and professional potential of minorities. If they are, then a good case could be made for exempting minorities from these criteria at this stage so as to allow concealed talent to be developed. But if, on the other hand, the criteria are accurately predicting future performance, then this exemption will just be the first of a limitless series, and it is not at all self-evident that a policy of perpetual favoritism can do much either to break down stereotypes or to foster social harmony. Unfortunately, much information is already in hand from the past decade of affirmative action showing that programs with a boundlessly elastic requirement for demonstrated academic aptitude but a rigid number of minority places to fill are distressingly prone to produce the latter result. . . . To start making such exceptions, it would seem, is to touch pitch.

Third, Mr. Jackson's serene faith that blacks are better protected by race-conscious than by race-neutral policies in a society that is overwhelmingly white is childlike. The true lesson to be drawn from the latter-day progress of blacks is *not* that the white majority has sincerely and irreversibly mended its ways, but that it can change its mind. So would it not be a wise precaution against a future change of mind to set in granite an absolute proscription *against* the government's making an official determination of a person's race and treating him differentially on this basis? . . .

William R. Havender,
University of California
at Berkeley

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Perspectives
on current developments

Snail Darters: Illustrating a Lawmakers' Dilemma

If a previously unknown species of fish were discovered in a river where a $100 million dam was nearing completion, and if operating the dam would condemn the species to extinction, would it be worth more to the public to save the dam or save the fish? In June 1978, the Supreme Court ruled on such a case, holding in *Tennessee Valley Authority* v. *Hill* that the Endangered Species Act of 1973 required the TVA to sacrifice the Tellico Dam in order to save the snail darter, a three-inch-long species of perch put on the Department of the Interior's "endangered species" list in 1975. In its subsequent efforts to devise a mechanism for making exceptions to the Endangered Species Act, Congress addressed a common regulatory conundrum: the problem of making rules both "reasonably flexible" and "free of loopholes."

Congress first appropriated funds for the Tellico Dam in 1967. Located on the lower section of the Little Tennessee River (near Knoxville, Tennessee), the dam is part of a larger development project designed to generate electricity, to control floods, and to promote economic development in the surrounding area. When in operation, the dam would create a thirty-mile-long reservoir covering about 16,500 acres, including some valuable farmland.

The Supreme Court's ruling in *TVA* v. *Hill* capped a decade of stop-the-dam efforts by local citizens (whose property would be flooded) and by environmentalists. In late 1973, when the Environmental Defense Fund lost a suit it had brought against the TVA in the U.S. District Court for Eastern Tennessee, the last legal barrier to the dam's completion seemed to have been cleared. But at about the same time, two events gave new leverage to opponents of the dam. One was the discovery of the snail darter in the Little Tennessee, and the other the passage of the Endangered Species Act of 1973. That act, among other things, directs the secretary of the interior to identify species "in danger of extinction" and to ensure that actions authorized, funded, or carried out by federal agencies do not "jeopardize the continued existence of such endangered species."

In January 1975, opponents of the Tellico Dam petitioned to have the snail darter classified as an endangered species. Secretary Thomas Kleppe did so in November and then, in April 1976, he formally declared those portions of the river inhabited by the snail darter to constitute the fish's "critical habitat" (an area critical for the species' survival). Clearly aiming to stop the dam, he also declared that all federal agencies must see to it that their actions do not result in the destruction or modification of this critical habitat area.

Meanwhile, even before the secretary issued these rulings, TVA began trying to end the Little Tennessee's status as a "critical habitat" by transplanting snail darters to the nearby Hiwassee River. Though snail darters have begun reproducing in the Hiwassee (TVA estimates that their numbers had tripled by 1978), the Department of the Interior has not been convinced that snail darters have established themselves securely enough in the Hiwassee to justify operation of the dam.

Despite the secretary's rulings, work on the dam continued, and in February 1976 opponents filed suit to stop it. In court, TVA argued (1) that the Tellico Dam was more than half completed when the Endangered Species Act became effective and 70 to 80 percent completed when the snail darter was officially listed as endangered, and (2) that Congress had approved new appropriations for the dam every year since 1967. Under these circumstances, TVA asserted, Congress could not possibly have wanted the act to block the dam. To substantiate this contention, TVA quoted from a June 1977 report of the Appropriations Committee of the House of Representatives: "It is the Com-

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In Brief–

No Red at Mars. The Mars Candy Company, makers of M&Ms, is now making only green, yellow, and brown candies. The red M&Ms have gone the way of the nickel candy bar—victims, however, not of inflation but of "regulatory spillover." The FDA banned Red Dye No. 2 and raised questions about its substitute, Red Dye No. 40—and Mars decided the publicity on the red dyes might lead candy eaters to assume that red M&Ms were dangerous. So shoppers wanting red and green candies for Christmas had to go to Mars Candy's competitors, who apparently decided regulation would not spill over on them.

Insulate with What? Energy conservation is hailed as a wave of the future, and insulation is seen as a major way of conserving energy and helping make the nation self-sufficient. But a funny thing happened on the way to the millennium. In fall 1978, with insulation sales in many areas down 30 to 70 percent from the previous year, insulation company officials were thinking that the federal government was speaking with a forked tongue—or at least a confusing one. There are eleven separate agencies that regulate, test, or advise on insulation—which makes it difficult for the companies to know what standards apply in particular cases and for consumers to obtain coherent information. Thus, while the President urges the country to insulate, CPSC is studying whether fiberglass—the most widely used product—is carcinogenic and is requiring that cellulose—the next leading insulator—be chemically treated to reduce its corrosiveness. Since, of the other two leading materials, rock wool is chemically similar to fiberglass and urea formaldehyde foam will sometimes shrink, stink, and make people sick if light reaches it (as it may with improper installation), this part of the energy-conservation program seems not to have much energy left. The agencies may be quite right, of course, but something seems quite wrong.

Update on Foreign Environmental Impact Statements. On January 4, President Carter issued an executive order requiring federal agencies to prepare environmental analyses before they approve "major actions significantly affecting" the environment outside the United States. The order followed a similar but stronger January 1978 proposal by the Council on Environmental Quality (see *Regulation,* May/June 1978). While it may resolve some questions on how the National Environmental Policy Act's requirement for environmental impact statements should be applied to foreign projects, it leaves plenty of room for disputes: agencies are to devise their own procedures for carrying out the order and, "where necessary," may modify their use of foreign environmental analyses for the sake of promptness, good relations, or "appropriate reflection" of such factors as export promotion, confidentiality, and national security.

Complaints and Kudos. The U.S. Office of Consumer Affairs is paying for a five-year study on how federal agencies are handling citizens' complaints, the study being carried out by Technical Assistance Research Programs, Inc. But TARP's December 1978 report attacks the Office of Consumer Affairs—as well as the Department of Labor, Department of Energy, and HEW—for lack of effective complaint-handling procedures. TARP charged that OCA, which is headed by Presidential Adviser on Consumer Affairs Esther Peterson, has failed to provide other agencies and departments with needed guidance on handling complaints, preferring to spend its time on communications received directly from disgruntled consumers. TARP also criticized some agencies for excessive reliance on the kind of handy form letters that rarely have enough specific information to be helpful, and for failing to adjust policies in response to citizen complaints. But the report commended three regulatory agencies—the FDA, FTC, and FCC —along with the Department of Housing and Urban Development for "dramatic improvements" and the CAB, CPSC, and Postal Service (which gets a lot of practice) for having good complaint-handling systems all along.

mittee's view that the Endangered Species Act was not intended to halt projects such as these in their advanced stage of completion and [the Committee] strongly recommends that these projects not be stopped because of misuse of the Act."

The Supreme Court's decision of June 1978 held, in a 6–3 vote, that operation of the dam would indeed violate the act. In an opinion by Chief Justice Burger, the Court emphasized that, aside from a few "limited 'hardship exemptions'" that clearly did not apply to the dam, the act "admits of no exception" in barring actions that could threaten endangered species. Furthermore, the Court held that Congress's repeated appropriations for the dam in no way reduced the force of the Endangered Species Act, because they represented "relatively minor components" of the TVA budget and because legislators are entitled to assume that appropriations will be devoted to lawful purposes. The Court also held that the House and Senate appropriations committees' stated beliefs that the act did not apply to projects like the Tellico were inconsequential, because only Congress as a whole can alter a statute.

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In response to a dissent by Justice Powell, who insisted that Congress could not possibly have intended that a $100 million dam and its associated public benefits be sacrificed for a species discovered long after construction had begun, the Court concluded that Congress plainly intended to "halt and reverse the trend toward species extinction, *whatever the cost*" (emphasis added). "Congress," the Court observed, "was concerned about the *unknown* uses that endangered species might have and about the *unforeseeable* place such creatures may have in the chain of life on this planet" (emphasis in original). Moreover, although previous statutes on preserving endangered species left substantial room for discretionary exceptions and although "every bill introduced in 1973 contained a qualification similar to that found in the earlier statutes," the 1973 act "carefully omitted" any such qualifications.

In handing down its decision, the Court was mindful of the costs:

> One might . . . [say] that in this case the burden on the public through the loss of millions of unrecoverable dollars would greatly outweigh the loss of the snail darter. But neither the Endangered Species Act nor . . . the Constitution provides federal courts with authority to make such fine utilitarian calculations. On the contrary, the plain language of the Act, buttressed by its legislative history, shows clearly that Congress viewed the value of endangered species as "incalculable."

Following the Court's decision, Congress amended the Endangered Species Act so that a project that threatens an endangered species can be granted an exemption if it is proven to offer greater benefits to the public than would be gained by preserving the threatened species. The amendment provides for a two-tier review process, whereby exemptions are allowed if approved by a three-person ad hoc review board and then by the Endangered Species Committee (which consists of the secretaries of the Departments of Agriculture, the Army, and the Interior, the administrators of the Environmental Protection Agency and of the National Oceanic and Atmospheric Administration, the chairman of the Council on Environmental Quality, and a presidential appointee from the state where the disputed project is located). As for the Tellico Dam, the amendment provides that its case for an exemption be given special attention: Tellico (along with the Gray Rocks Dam in Wyoming) has bypassed the review board and gone directly to the Endangered Species Committee, and will *automatically* receive an exemption if the committee does not deny one within ninety days of the President's November 10 signing of the amendment. As of early January 1979, the committee was beginning to hold hearings on the dam.

It is easy to criticize Congress for drafting legislation so rigid as to preclude any weighing of costs and benefits. On the other hand, as frustrated members of Congress have often observed, to give agencies much discretion for "reasonable exceptions" is to give them latitude to ignore legislative intent. The statutes that were superseded by the Endangered Species Act of 1973 instructed federal agencies to preserve endangered species, but also granted the agencies latitude to give that goal a low priority—too low, in the view of many interested parties. Perhaps some members of Congress favored making the act rigid because they feared that anything less would not adequately protect their favorite endangered species.

In any case, it is difficult to devise general rules tight enough to save "important" animals —for example, the grizzly bear and the bald eagle—without unwittingly requiring that the public also make sacrifices to save "unimportant" ones such as the snail darter.

Battling Carcinogens Systematically: New Strategies at OSHA and CPSC

"Trying to control carcinogenic substances on a case-by-case basis is like trying to put out a forest fire one tree at a time." This attitude, voiced in October 1977 by Secretary of Labor Ray Marshall, underlies the efforts of the Occupational Safety and Health Administration and the Consumer Product Safety Commission to address cancer-causing substances in a more systematic way than they have traditionally. The policies they are moving toward would greatly increase each agency's capacity for promulgating new regulatory standards and thus for developing comprehensive and stringent programs for controlling carcinogens.

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In a sense, it is impossible to achieve true comprehensiveness in regulating carcinogens. There are roughly 2,000 substances that have been identified as "suspect carcinogens" and the number is growing. (In the past ten years, the production of synthetic organic chemicals—among which new suspects are being identified all the time—has expanded by over 250 percent.) Whenever an agency promulgates a new standard limiting the use of a substance, it must give all affected parties an opportunity to contest the standard and to propose alternatives. Needless to say, rulemaking proceedings on carcinogens are controversial and time-consuming. For example, on vinyl chloride, OSHA needed a full six months to hold hearings, to solicit written comments, and to review the resulting 4,000-page record before it could publish a final rule—even though this was a top-priority matter for which OSHA borrowed resources from other projects. So far, OSHA and CPSC have completed respectively nine and four rulemakings on carcinogens, producing limits or bans on a combined total of twenty-six substances.

In such rulemakings, the controversy generally centers on two questions: (1) Is the evidence on record sufficient to prove that a substance (or product containing the substance) should be treated as a cancer-causing threat to humans? (2) If so, how strict a rule is needed to achieve an acceptable degree of safety?

In the past, OSHA and CPSC have addressed carcinogens on an ad hoc basis and thus have had to confront these questions from scratch in each case. There have been no controlling assumptions on how much weight to give to various types of evidence (for example, positive or negative results from either animal or human studies) and no established guidelines for translating a finding of carcinogenicity to a final standard (that is, no presumptions that evidence having 'X' degree of conclusiveness would lead to a regulatory remedy with the stringency of 'Y'). Thus, in each proceeding, OSHA and CPSC not only have had to examine evidence on the substance at issue but also have had to spend a great deal of time and resources reestablishing their general principles for evaluating carcinogens.

To alleviate this problem, OSHA in October 1977 proposed a rule entitled "Identification, Classification and Regulation of Toxic Substances Posing a Potential Occupational Carcinogenic Risk." If adopted, the rule will serve as the agency's fundamental guideline for promulgating new standards on carcinogens. Having completed hearings last July and having finished gathering written comments in late December, OSHA is expected to promulgate a final rule this spring.

With intent similar to OSHA's, CPSC in June 1978 issued an interim policy statement entitled "Classifying, Evaluating and Regulating Carcinogens in Consumer Products." This statement explains the policies and procedures CPSC is seeking to follow until it institutes a formal rulemaking proceeding (which has not yet been scheduled). On November 1, a U.S. district court held that CPSC's implementation of the statement on even a tentative basis before completing formal rulemaking violates the Administrative Procedure Act. CPSC has filed for reconsideration.

What makes OSHA's and CPSC's proposed new policies "systematic" is that they would establish principles and procedures applying to all of their proceedings for promulgating standards on individual carcinogens. The proposals use similar criteria for evaluating evidence on whether a suspected carcinogen actually poses a threat to humans. Both generally would consider positive results from one test on humans or from two long-term tests on other mammals to be "strong" evidence, and would consider positive results from one long-term test or from a number of short-run tests on mammals as "suggestive" evidence. Results would be considered positive if a substance significantly increased the incidence of either malignant or benign tumors in test subjects. In justifying their decisions to consider benign tumors (which are not cancerous), OSHA and CPSC noted that benign tumors can be hazardous both in their own right and because they may become malignant. In experiments with animals, both agencies also accept the validity of high-dosage testing (that is, administering larger doses for a given body weight than humans are exposed to), their reasoning being that tests using "normal" dosages may fail to detect threats to humans. Both agencies, while recognizing that risk tends to decline as dosage falls, reject the idea of a "threshold" dosage below which a carcinogen may be considered completely safe.

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The agencies' heavy reliance on animal-test results stems partly from the limitations involved in epidemiological tests on humans. For moral and other reasons, it is not possible to use the tight experimental controls in human tests that can be maintained in laboratory tests of animals (thus, human "testing" is generally confined to retrospective comparisons between cancer rates in groups whose work or lifestyle exposes them to a suspected carcinogen and rates in groups without such exposure). In the absence of those controls, test results may be distorted by substances not detected by the test; tumors attributed to the substance being tested may in fact be caused in whole or part by other substances. An even more serious problem with human tests is that cancers in humans typically have a very long latency period—up to forty years. It is therefore possible for a carcinogen to put a cancer "in seed" in epidemic numbers before it could be detected by human tests. In view of this problem, mammals such as rats and mice (which have a proven susceptibility to virtually all agents known to cause cancer in humans and can be tested at much lower cost) are especially useful for testing because their cancers have much shorter latency periods—typically only one or two years.

Under OSHA's proposal, substances that are found in the workplace and that have produced either "strong" or "suggestive" evidence of carcinogenicity would automatically be subjected to rulemaking that would produce an exposure standard. In the case of the strong-evidence substances, OSHA would immediately impose an emergency temporary standard that would remain in effect until completion of the rulemaking proceeding. (A preliminary study commissioned by OSHA predicted that 116 chemicals that are produced in "significant" amounts would qualify for the strong-evidence category.) All of these standards would be based on "model" standards included in OSHA's proposal.

In promulgating standards, OSHA would set occupational exposure limits "as low as feasible." Where "suitable substitutes" are currently available or could be developed in the near future, OSHA would not permit any exposure. Although OSHA originally intended "feasible" to mean as low as technologically possible without inflicting severe financial injury on affected firms, a recent court ruling has rendered OSHA's future interpretation of "feasible" very much in doubt: last October, a U.S. court of appeals struck down OSHA's benzene standard on the grounds that OSHA lacked sufficient evidence that benefits from the standard would exceed the costs.

Under CPSC's proposal, there would be automatic evaluation of the risk attached to products containing substances for which "strong" evidence is found and discretionary evaluation in cases of substances for which lesser evidence is available. In evaluating risk, CPSC would consider, among other things, the substance's apparent potency as a carcinogen, the extent to which the product exposes the population to the substance, and the social and economic effects that would accrue from a ban on products containing the substance.

If CPSC determined that continued use of a substance in consumer products would impose a significant risk of cancer on the population, it would ban the substance—unless the ban would impose unacceptable social and economic costs (stemming from the importance of products containing the substance and the unavailability of suitable substitutes), in which case CPSC would require a reduction of the substance to the "lowest attainable level."

Both agencies' proposals have aroused tremendous controversy—and not because all of the opponents would like OSHA and CPSC to continue "fighting forest fires one tree at a time." The potential costs and benefits of the policies are in furious dispute. For example, a study commissioned by the American Industrial Health Council estimated that regulations resulting from adoption of OSHA's proposal would involve annual compliance costs of $6 to $36 billion and require capital expenditures of $9 to $88 billion, depending on how the proposal would be implemented. But defenders of OSHA's proposal contend that such figures are too high and that the implementation of the proposal would generate health benefits far exceeding actual compliance costs.

OSHA and CPSC are trying to get away from the one-tree-at-a-time approach, but even those who agree with this endeavor need not agree how to fight the fire—and it is not at all sure that the disagreement will produce more light than heat.

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Dress Codes and Sports: HEW Applies Some "Common Sense" . . .

Should the federal government be telling local school authorities that they may not forbid boys from wearing their hair to their shoulders or forbid girls from wandering about in a provocatively bra-less state? Health, Education, and Welfare Secretary Joseph Califano recently announced that "most Americans feel" these questions "are handled with more common sense at the local level" and that HEW would change its regulations accordingly.

Is Ohio State spending enough to encourage women students to enter sports competition, considering all the attention and funds it gives to its famous—male—football team? While Secretary Califano has not offered his reading of what "most Americans feel" about this question, he has made it clear that it will *not* be left to "common sense at the local level."

On December 3, 1978, Secretary Califano announced his department's intention of amending its regulations against sex discrimination in educational institutions by deleting the section forbidding discrimination "in the application of any rules of appearance." But at the same time he announced a stricter, or at least a more detailed, interpretation of HEW rules on sex discrimination in college sports programs. Both decisions must be approved by the President and are technically subject to veto by a joint resolution of Congress, but—judging from past experience—HEW will be left to make them on its own. How it came to be in a position to make such decisions is probably more significant than the immediate consequences of either proposal.

Back in 1972 Congress sought to promote sex equality in government programs by enacting Title IX of that year's education amendments. In terms borrowed directly from the ban on race discrimination in Title VI of the 1964 Civil Rights Act, Title IX prohibited discrimination in "any program or activity receiving federal financial assistance"—though the ban in this case was applied only to "education" programs or activities. Title IX also includes a "pinpoint provision" specifying that any funding cutoff to enforce compliance with the statute "shall be limited in its effect to the particular program or part thereof in which such noncompliance has been so found."

HEW was widely criticized by women's groups for taking three years to draw up the implementing regulations for Title IX, but the delay is not surprising when one considers the ambitious scope of what the department produced: HEW proceeded as if Title IX's ban on sex discrimination applied not to particular programs receiving federal funds but to any program that takes place at an educational institution receiving federal assistance in some capacity—whether or not the assistance is direct or the program is strictly "education." Thus the regulations promulgated in 1975 imposed an elaborate set of requirements to prevent discrimination in employment practices, covering every position from cafeteria worker to dean; they specified the proper handling of pregnant students; and they directed the conditions under which physical education classes must be sexually integrated. They also covered, among other things, the operation of dormitories, infirmaries, sports programs, and virtually all extracurricular activities.

Is this really what Congress intended? Several district court judges have ruled in cases over the past two years that the employment section of the regulations goes beyond what Congress authorized in Title IX (since employment is not an "education" program or activity, even when the employer is a school). While HEW is appealing these decisions, other portions of the regulations may also be vulnerable to challenge on the same grounds. Whatever the courts may determine, the truth is that Congress contented itself with voicing a national consensus on the vague ideal of equal opportunity for the sexes and then left it to HEW to settle the tough questions about how this ideal ought to be interpreted in particular situations.

Secretary Califano's new proposals are a good illustration of what is disturbing about this practice. To many it has seemed a trifle absurd to have a *national* policy on whether schools and colleges—including private ones—may require dress codes, and altogether absurd to say that schools may not require boys to wear ties or girls to wear dresses without imposing the same requirement on the opposite sex. But if HEW finds reasons to leave this issue to "common sense at the local level," why does it not do the same with rules affecting dormitory use, evening curfews, or health-care facilities—to cite a few examples of what remains in

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the regulations? So far, HEW has remained silent on this question.

HEW cannot even contemplate deleting all provisions on sports, however, since Congress explicitly required that intercollegiate sports be covered in the Title IX regulations "in some reasonable manner." But what is "reasonable"? In his December 3 announcement, Califano reiterated the existing policy of refusing to exempt revenue-producing sports like football from Title IX coverage, despite intense urging by college athletic associations. But he did note that the new requirement for equal per capita spending for men's and women's sports programs (with expenditures for each college based on the number of participants of each sex in its existing athletic programs) might be relaxed for institutions which show that the differences are based on "non-discriminatory factors, such as the costs of a particular sport (for example, the equipment required) or the scope of the competition (that is, national rather than regional or local)." Perhaps this is a reasonable compromise between the claims of women's rights advocates for more encouragement to women's athletics and of sports directors fearing diversion of resources from prominent or well-established men's teams. But in practice it means that HEW inspectors will be deciding on a case-by-case basis whether the adjustments arrived at by particular colleges are "reasonable."

Secretary Califano's decision to scrap the regulations on dress codes may have been intended to make the department's Title IX enforcement less controversial or obtrusive. But the tacit admission that HEW retains wide discretion to decide which areas of potential "sex discrimination" to address may fuel more future controversy than will be allayed by this precedent of deferring to "common sense at the local level."

. . . But Not Everywhere: HEW-ing at Hillsdale

The difficulties of Hillsdale College provide another example of how far HEW takes its regulatory authority under Title IX of the 1972 education amendments (see "Dress Codes and Sports," page 10, above). Not that Hillsdale was HEW's solitary target. Indeed, by December 1978 some 20,000 colleges and school districts had been asked to sign HEW's standard "assurance of compliance" with Title IX (most of them unquestionably receiving federal funds). Nor was Hillsdale the only institution that balked at signing the assurance. Initially twelve colleges and thirty-eight school districts did not sign. But all of them eventually did when HEW threatened to cut off funds, except for Hillsdale (a small liberal arts college in Michigan) and Grove City (ditto in Pennsylvania).

Hillsdale has made a point of refusing any federal aid, hoping thereby to remain free from the federal regulation that accompanies the aid. But HEW argues that the college is subject to Title IX because some of its students receive federal loans and grants. The college, while insisting that it does not practice any sex discrimination (and HEW has not charged it with practicing any), takes the position that it is only certain students, and not the institution, that are receiving aid—and, moreover, that HEW is exceeding the scope of its statutory authority. At most, the college argues, it should be held to account for administering the student aid funds in a nondiscriminatory manner.

Grove City made the same claim but was ordered by an HEW administrative law judge to sign the assurance or have its students lose their aid. The administrative law judge in the Hillsdale case, however, handed down a decision whose calculated ambiguity rivals that of the Supreme Court in *Bakke*. In August 1978 he ruled (1) that acceptance of federal aid by Hillsdale students does indeed subject the college to HEW regulations, but (2) that Hillsdale's refusal to sign the assurance does not by itself entitle HEW to suspend the student aid, even though the regulations require Hillsdale to sign. The judge held that judgment on the extent of Hillsdale's obligation to HEW—or the extent of HEW's authority to regulate areas apparently unrelated to an "education program or activity"—should be deferred until such time as HEW's Office for Civil Rights charged the college with a substantive violation.

Although both sides in the Hillsdale case have suggested that the administrative law judge's decision was "essentially" in their favor, both have pressed their objections before the HEW secretary's reviewing panel for such cases. It will be months before this panel (now being reorganized at Secretary Califano's direc-

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tion) delivers its judgment and—given the likelihood of appeals to the courts (Grove City has already appealed)—quite possibly years before the underlying issues are finally resolved.

One wonders if—perhaps—this too might be an area for the exercise of "common sense," whether local or within the Office for Civil Rights at HEW.

NHTSA and the Firestone 500

One of the two largest product-related causes of U.S. auto accidents is tire failure, and the most publicized tire failure to date is that of the Firestone 500—Firestone's erstwhile top-of-the-line, steel-belted radial. On November 29, 1978, following an acrimonious public debate, the National Highway Traffic Safety Administration and the Firestone Tire & Rubber Company signed an agreement specifying the terms for recalling an estimated 13 million of these tires —the largest product recall in history.

The case against the Firestone 500 rested on evidence that the tire's failure rate and likelihood of causing serious accidents were exceptionally high. NHTSA is empowered to order recalls of motor vehicles and accessories that either fail to meet its specific standards for design and test performance or exhibit other evidence of a safety-related defect. The 500s, except for some 400,000 of them recalled in early 1977, did not violate any of NHTSA's specific standards, but they had accident and adjustment rates far greater than those of other tires. Specifically, by July 1978, NHTSA had gathered reports of sixty-four injury-producing accidents and thirty-four fatalities that involved Firestone 500s. By contrast, manufacturers' reports covering steel-belted radials sold domestically by Firestone's seven leading competitors showed only twenty-one fatalities for eight times the number of tires. Furthermore, between 1972 and March 1978, the overall adjustment rate for the 500s (percentage of tires returned by customers and accepted by manufacturers for pro-rated credit toward new tires) was 17.5 percent, against only 1.7 to 5.3 percent reported by Firestone's seven leading competitors for their steel-belted radials (and 5.5 percent for Firestone's other steel-belted radials).

Thus, in July, NHTSA announced an initial determination that the 500s contained a "safety-related defect" and might therefore be subject to recall. Firestone, however—both then and throughout the proceedings—contended that the 500s were safe, dependable, and free of fundamental defects. It argued that the chief cause of failure had been the widespread and persistent tendencies of drivers to keep their tires underinflated, thereby irreversibly damaging the tires and making them dangerously susceptible to failure. It discounted the adjustment-rate figures on the grounds that it had been unusually accommodating to customers who were dissatisfied with the 500. Finally, Firestone noted that no one had identified any specific defects in the tire and that the tire's reliability, rated in NHTSA's own tests, was the "highest . . . of any tire ever manufactured by Firestone" and "far in excess" of agency requirements.

In August 1978 the Subcommittee on Oversight and Investigations of the House Commerce Committee issued a report that rebutted many of Firestone's arguments. The report (based on subcommittee hearings in May and June 1978) contended, among other things, that manufacturers should make tires sufficiently durable to withstand—at least to a reasonable extent—such recognized common abuses as underinflation. For a company to do otherwise, the report suggested, is for it to produce tires with the expectation of having them fail.

In a supplementary opinion attached to the report, Subcommittee Chairman John Moss (Democrat, California) observed that Firestone's sales literature and ads had not, until very recently, warned consumers about the critical importance of keeping the 500s properly inflated—although (as a Firestone engineer had testified) underinflation of four pounds per square inch represented "the threshold of trouble" for the tire and six to eight pounds underinflation meant "trouble for sure."

NHTSA was stymied in ordering a recall by Firestone's refusal to provide the information requested. By withholding information, the company even enabled itself to defend the tires with arguments that were refuted in its own records. For example, Firestone insisted for many months that the overall adjustment rate of the 500s was 7.4 percent rather than the actual figure of 17.5 percent. More seriously, although Firestone claimed it had no indication of any safety problems with the 500 until

(Continues on page 60)

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Viewpoint

John T. Dunlop

New Approaches to Economic Policy

IT WAS THE BEST of times. From 1900 to the 1970s there was unprecedented economic growth and unprecedented improvement in the living standards of the common man in advanced democratic countries. Real wages were increased three to five times, weekly hours of work were reduced by 25 to 35 percent, and life expectancy went up sharply. Average years spent in education grew substantially. These countries became welfare states offering a spectrum of public and private policies designed to protect workers, employees, and citizens from the risks of illness, retirement, accidents, disabilities, and involuntary idleness, and to facilitate access to housing, education, and training. Collective bargaining and worker participation in the decisions of the work place grew to major importance.

Then suddenly, in comparison, it seemed the worst of times. The advanced democratic societies confronted markedly higher energy costs, adverse impacts from the insistent aspirations of developing countries, conflicts and incongruities among their economic plans, slow growth, and continuing inflation and unemployment. In the eight years from 1970 to 1977 consumer prices in the United States rose at 6.5 percent per year and unemployment averaged 6.3 percent. The fact that real hourly earnings in the private sector had not recovered by 1977 to the 1973 levels created doubt that the economy or economic policy-makers could ever again produce a doubling of living standards every generation.

Perhaps the experience of the 1970s—this climacteric, watershed, or aberration as you like—has its roots in the premise that economic policy is somehow capable of determining and, by its own will, producing desirable results with regard to growth, unemployment, and inflation. In any event, the premises of government's role in economic policy require brief comment.

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Politics, Policy, and Government Penetration

A prime role of the political process is to articulate the common aspirations of the people. This function is not to be demeaned by technicians or administrators, but neither are the aspirations to be confused with reality or with the possible. In collective bargaining, the parties each develop their bargaining proposals or dream books, but in mature relations no one confuses demands with reality to the extent that politicians do in the economic arena.

Economic policy has been historically conceived in the main as concentrated upon fiscal and monetary measures. Economic growth, unemployment, and inflation have been assumed to be shaped through these classical policy instruments, while the rest of the economy has been assumed to be dominated by private decisions adapted to the general economic environment shaped by general government policies.

The economy of the 1970s, however, has been characterized by significant growth in direct government involvement in individual markets and in the decisions of enterprises and groups. The detailed involvement of public agencies in pricing (as in agriculture, in public utilities, and through incomes policies), the vast expansion of regulation in the areas of health, safety, pensions, environment, standards of service, and discrimination, the detailed negotiations of international trade arrangements, and the regulation of wages and working conditions now far exceed previous experience. Given this unparalleled expansion in the

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scope and detail of government penetration into private decisions, including collective bargaining, previous assumptions about government and economic policy are probably no longer valid.

At least two features of this new penetration, at any rate in the United States, deserve attention. First, there have come to be so many new political and legal centers of decision-making, uncoordinated by the market or by a central political force, that they have created vast uncertainties that private parties have been unable to comprehend or incorporate into viable plans. Consider the state of legislation, regulation, and litigation relating to energy or to the environment, and it becomes clear that the uncertainty of private decisions has been enormously increased. Second, the deep penetration of government regulation introduces a short-term perspective, reflecting the tendency for political considerations to change frequently and for government policy officials to have a short tenure in office.

Since government economic policies today (beyond general fiscal and monetary measures) include a host of specific measures and regulations, without central direction, the notion that government is a single or coordinated decision-maker defies reality, at least in the United States. The result is a new, strange, and often hostile economic environment for growth, employment, and price stability.

The traditional tools of macroeconomic analysis do not suit a world of pervasive and penetrating government. When product and labor markets already reflect governmental interventions, they do not readily respond to general fiscal and monetary policies. Indeed, the whole complex of internal and external governmental interventions so complicates analysis that prediction of the consequences of general policies becomes hazardous, and the general economist, whether attached to the Treasury, a central bank, or an economic planning agency, becomes less useful.

New Approaches to Economic Policy-making

The approach of the last generation has been dominated by aggregate technical economic concepts—among them the Phillips curve and Okun's law. But in the 1970s aggregate quantities and relationships have often proved misguided, if not treacherously misleading.

To put it briefly, economic policy-making would do well to adopt an approach characterized by five somewhat neglected elements. This approach should supplement, not displace, appropriate fiscal and monetary policy.*

(1) Analysis needs to be sectoral as well as aggregative. Agriculture, energy, housing, industrial goods, and health services, for instance, must be understood not only separately but in their reactions upon other sectors. The elements of wage and benefit setting, price determination in various sectors, and the consequences of direct governmental regulations and tax measures must be incorporated in the analysis.

(2) The approach must be institutional as well as analytical. To prescribe regarding wages without an understanding of collective bargaining and the policy-making processes of large nonunion enterprises and all small businesses is to invite wide errors, unreality, and unnecessary hostility.

(3) The approach must be political, to a degree, as well as economic—"political" in the sense of being grounded in the art of the possible, and particularly the possible consensus among large elements of the relevant groups. This is not to rule out an occasional good fight but to emphasize that the political process can tolerate relatively few serious contests.

(4) The approach must involve both domestic concerns and, as never before, an international perspective. Inflation in some major elements has been a worldwide phenomenon; economic growth in many countries is significantly affected by the domestic and trade policies of trading partners.

(5) There must be less resort to direction ("command and control") and regulation and more to consensus building and persuasion. Consensus building requires not merely broad general public support but participation and de facto acceptance by major interest groups —including large and small business, labor,

*As George P. Shultz has noted, "The great vice of wage and price controls is not so much that they work poorly or that they are an inappropriate response to inflation as it actually occurs in our economy, but rather that they induce government to relax monetary and fiscal policy" (in George P. Shultz and Kenneth W. Dam, *Economic Policy beyond the Headlines*).

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and others. The politics of the electoral process (including television) may yield vote pluralities but only consensus building with major groups can produce the capacity to govern in the field of economic policy.

Policy and Program Areas

There is an enormous world of studies, reports, and pronouncements on the subject of growth, unemployment, and inflation in our times. My present purpose is to give a view on these issues which reflects my experience, without being unduly concerned as to the general acceptability of these judgments.

Inflation is not just a single malady with a single treatment. Each period of rising prices and wages in the postwar world has been quite distinctive. In 1946–48, there was a pent-up surfeit of liquid assets searching for scarce goods in the aftermath of war. In 1950–51, there was a sudden change of price expectations in world primary markets as a consequence of the sudden onset of the Korean War. In the late 1950s, there were cost pressures arising from large wage settlements that carried over to periods of soft demand and higher agricultural prices. In the late 1960s, there was insufficiently tight fiscal policy in the face of large expenditures associated with the Vietnam War. In 1972–73, there was a variety of factors including agricultural developments, monetary policy, the oil embargo, and the dollar devaluation. The basic point is that policy must recognize the special features of each period of inflation. A single prescription is not likely to be appropriate.

There are important structural respects in which the economy has now entered a period of greater inflationary pressures. It has been recognized for some years that money compensation always moves upward in the modern society, the social costs of downward adjustments being too great. But it has not so clearly been recognized that periodic bursts of inflation in agricultural prices, housing costs, and local taxes get more and more "baked in" with higher property values rather than being generally reversible. Lower rates of productivity (arising from a variety of factors including changes in the composition of the labor force), social charges for environmental and other concerns, higher energy prices, and low capital formation all contribute to compensation increases being translated into higher prices.

I agree that governments should regularly discuss basic issues (the course of prices and wages, unemployment, economic growth, and appropriate policies) with the organizations representing business and labor—though I have difficulty with the 1977 statement of the OECD committee of experts that links the discussions with a target or guideline for wages and prices, which I oppose. But whatever that maligned term "incomes policy" may mean in the United States, there appears little likelihood—in the absence of a genuine emergency—of policy agreement among labor, management, and government in the foreseeable future. Moreover, if incomes policies simply try to reduce wages or price increases, leaving everything else the same, little if anything can be accomplished. The successful voluntary programs are those that induce changes in the underlying factors, something that requires consensus.

In the United States, formal government controls with a tripartite board are a more likely course of development than the sort of structural changes that would be required in the national levels of labor and management organizations to make an incomes policy based on these organizations at all administrable. With nine years of experience administering wage and price controls in the United States, I am simply not an advocate.

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Rather, on the wage and benefit side, we should seek to bring about (1) reform in the structure of bargaining so as to reduce rivalries and "leapfrogging," (2) the elimination of outdated work rules, practices, and manning requirements, (3) reform in methods of wage payment, (4) the improving of productivity in other ways, (5) the recasting of fringe benefit packages and their financing, (6) improvements in labor supply and training, and (7) specialized agreements to meet the problems of particular branches or plants in an industry. Programs of this sort take time to develop and

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require cooperation and trust and personnel with detailed sectoral knowledge. They cannot be imposed by government jawboning or arm-twisting. They can be developed only by persuasion and by imaginative and patient leadership.

On the price side, the future course of prices can be affected by (1) giving early attention to capacity needs, as revealed by discussions of potential bottlenecks; (2) encouraging government programs that enhance rather than restrict supply; (3) stimulating investment and cost-reducing outlays; (4) attending to the "interface" areas where manufacturing, transportation, and finance meet; and, particularly, (5) attending to government activities and regulations which create uncertainty and increase costs unnecessarily.

Let me turn briefly to other areas. The last decade has certainly demonstrated that unemployment is not a simple target of policy. The labor force is susceptible to a variety of short-run and long-run influences that make prediction and policy prescription most difficult. No single aggregate unemployment figure is appropriate as a guide to economic policies. Instead, we will need to look at labor market conditions by age, skill, locality, industries, and degree of disadvantage. It is not the aggregate measures but the wealth of detail that is relevant to appraising potential shortages and inflationary pressures arising within the relatively few decisive markets.

The targeting of public programs on particular categories of the labor force may be appropriate policy, but greater involvement of the private sector in job creation is necessary if good, continuing jobs are to be developed. Existing public service programs are in the main unsatisfactory, save as a method of income maintenance. We need new forms of non-governmental organizations to provide training and to encourage job creation for the hard-to-employ.

With respect to growth, the stagnation of the economy since 1973 reflects, no doubt, many short-term and structural factors. The two elements that appear most significant to me are uncertainty in government policies on a variety of fundamentals (including energy, the environment, and regulatory conditions) and the resulting tendency for low levels of investment in modern plant and for concentration of investment outlays on machinery and equipment rather than on longer-run plant and developmental expenditures. In this climate of uncertainty, government economic policies, including fiscal stimulus, cannot have the favorable effects on the economy they have been presumed to produce.

Finally, I would note the unusual amount of controversy over international trade policy in the United States, reflecting deep concern over, first, trade involving Asian and Communist countries (particularly with regard to shipping and advanced technology items with security implications) and, second, trade involving labor-intensive items which threaten to displace large groups of relatively low-paid workers. The U.S. labor force includes very large numbers of low-productivity workers who cannot easily be converted to more productive activity and who are not willing to settle for displacement pay in various forms. Economic policy in this area requires imaginative attention to work out problems with those affected, not to mention skillful negotiations with our trading partners abroad. I fear we do not well understand how explosive these issues are.

The Watershed

The 1970s, in my view, constituted a watershed of economic policy, the difference in the United States deriving from the new and pervasive role of government and its adverse effects on growth and inflation. While there was, no doubt, "an unusual bunching of unfortunate events unlikely to be repeated on the same scale" (in the words of the 1977 OECD report), my judgment is that the difficulties are more fundamental. They relate to (1) the methods of making economic policy and (2) the substance of the decisions derived from the political process and from its massive new penetration into all manner of heretofore private economic activities. Neither private businesses nor collective bargaining agents nor governments have yet adapted—together or separately—to this new state of affairs: they seem to believe it is still the "best of times." ■

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ON CARTER'S ANTI-INFLATION POLICY

Alan Greenspan, Alfred E. Kahn, Marvin H. Kosters, and Rudolph Oswald

JOHN CHARLES DALY, moderator of the forum and former chief of ABC News: For nearly a decade and a half, the United States has been struggling with an inflationary economy at home, while keeping a wary eye on the often dramatic struggles with inflation going on abroad. There is the sense that, as with the common cold, we are not sure where inflation came from or what we can do about it.

At the beginning of 1978, President Carter initiated a voluntary program under which government, business, and labor, inspired by persuasion and publicity, would cooperate in an anti-inflation effort. But the results were disappointing. So, on October 24, 1978, the President issued an urgent call to battle. First, he promised to cut the budget deficit, restrain the federal payroll, delay further tax cuts, remove needless regulations, and encourage more competition. Second, he asked labor and business generally to limit wage increases to 7 percent and price increases to 5¾ percent. And third, he proposed, in order to encourage labor cooperation, a real wage insurance plan under which workers who observed the program's wage standards would be eligible for tax rebates if the inflation rate should exceed 7 percent. These, then—if the Congress approves the necessary legislation—are the principal weapons in our arsenal against inflation.

Dr. Kahn, recently President Carter said that "with more than a thousand different kinds of decisions to be made, there will be some flexibility." Do you and the President anticipate any major modifications in the program?

ALFRED E. KAHN, adviser to the President on inflation: One could not legitimately characterize the two modifications we have in mind as major. The first would be a response to the almost unanimous criticism by business and labor that our treatment of fringe benefits—and in particular of the catch-up costs of maintaining existing levels of benefits—is simply too stringent. We are thus contemplating a number

Alfred E. Kahn, adviser to the President on inflation, formerly was chairman of the Civil Aeronautics Board (1977–78) and of the New York State Public Service Commission (1974–77). Alan Greenspan, chairman and president of Townsend-Greenspan and Co., Inc., formerly was chairman of the Council of Economic Advisers (1974–77). Rudolph Oswald is director of the Department of Research at the AFL-CIO. Marvin H. Kosters, resident scholar and director of the Center for the Study of Government Regulation at AEI, formerly was associate director of the Cost of Living Council (1971–74).

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of possible ways of introducing a modicum of flexibility in this area. The second modification would be a response to an obvious point made by labor—and one I made in testimony back in 1971—that a standard permitting both the pass-on of uncontrollable costs and a fixed percentage margin in effect permits additional profits to be earned on additional costs. We are trying to devise ways of preventing this.*

MR. DALY: Dr. Greenspan, how does President Carter's program compare with President Ford's WIN program?

ALAN GREENSPAN, president, Townsend-Greenspan and Company: If I can divide President Ford's WIN program into two parts—one, a call for severe restriction on federal spending and thus on the budget deficit, and the other, something of a vague freeze—I would say the two programs are quite similar, with similar problems. In my view, all that is desirable—and, in fact, all that is necessary—to restrain inflation comes in the first part of both programs, that is, in the restraint on federal spending and indirectly on government's credit-creating capacities. The second part of the programs—the guidelines—is counterproductive. Indeed the guidelines, rather than being anti-inflationary, will ultimately add to inflation. They were a wholly inappropriate response to inflation under WIN, and are again today.

MR. DALY: Dr. Oswald, would you summarize labor's objections to the President's program?

RUDOLPH OSWALD, director of research, AFL-CIO: Organized labor objects that the wage controls are not voluntary, but mandatory. There is an enforcement mechanism for wages because every employer will be willing to enforce the wage guideline of 7 percent. On the other hand, contrary to what you said in your introduction, there is not a 5¾ percent guideline on prices: the only price guideline mentioned is 9½ percent. Moreover, the program provides for a half percent deceleration from the rate of price increase that took place in 1976–77—which says that those who raised prices the most in those years can do so again, and those who were most socially responsible can do less now. That hardly seems equitable. Moreover, there is not really a mechanism for controlling prices: there is no manpower to do it, the consumer does not know what an appropriate price increase is, and no other source of income is controlled except wages. It is for this reason that the labor movement has asked for mandatory controls, established by legislation, effectively enforced and applying to all segments of the economy, not just to wage-earners.

MR. DALY: Dr. Kosters, drawing on your experience at the Cost of Living Council, do you think the program will work?

MARVIN H. KOSTERS, director, Center for the Study of Government Regulation, AEI: There are two ways of addressing that question. The first is to ask, Is the program likely to break down?—that is, might there be a wage or price increase that seems so much out of line with the standards that the whole program is discredited? That of course can happen in any program. In the program I was involved in from 1971 to 1974, we said cases like that were "the last cows in the barn," and they had to be let out on equal terms with the cows already out. But one can say that only so long before the explanation wears thin. Nevertheless, there are good reasons for above-average increases. It is insufficiently appreciated that any average of wage increases, or of price increases, involves a great deal of variation—with some below and some above the average. And a large wage increase or a large price increase can make a program appear to fail.

The second way to address the question is to ask, Is the rate of inflation likely to be lower after the program than it was before? By virtue of the standards themselves, that is quite unlikely. All the experience I know of in Europe and the United States is negative, and I see no reason for expecting this program to fare any better.

MR. DALY: The man who was chairman of the Council of Economic Advisers from 1971 to

*EDITOR'S NOTE: On December 13, 1978, the Council on Wage and Price Stability (1) relaxed the 7 percent wage guidelines and (2) tightened the price guidelines. Certain increases in the costs of pension plans will be exempt. Increases in costs from previously negotiated health benefits will be deemed to be 7 percent unless they are less. Companies whose circumstances preclude their following price increase restrictions must limit increases in pretax profits to 6.5 percent plus whatever is produced by increased volume.

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1974, Herbert Stein, has written that two lessons from the last decade of struggle with inflation are relevant today: "One, do not think we can flirt with controls and not get them. And, two, do not think that the ineffectiveness of controls, which has roots deep in the American economic and political system, can be overcome by sufficiently enthusiastic operators."

How say you to that, Dr. Kahn?

DR. KAHN: The notion that any kind of controls or incomes policy can only do harm seems to me to spring from an assumption that the wage increase which, for example, the Teamsters settle for is somehow God-given or competitive-market-determined in the same way the free price of natural gas would be if gas were uncontrolled. But there is an enormous difference between these two. If we hold the price of natural gas below its marginal cost, we will have shortages. But does anyone on this panel believe that if we can induce the Teamsters (by one device or another) to reduce their wage settlement from 11 percent to, say, 7 percent we will have a shortage of Teamsters? Is there anyone here who believes this is a competitive market which by University-of-Chicago/God-given standards should not be interfered with? That view, I submit, would be an absurdity.

... I do not believe it is right to speak of many of these prices and wages as though they were determined in a competitive market in such a way that to interfere would produce enormous distortions in the economy.

—Alfred E. Kahn

I am not suggesting these weapons are the total answer. I am not, as you know, an enthusiastic supporter of the guidelines. I have been quoted correctly as referring to them as "those stinking wage-price guidelines." On the other hand, I do not believe it is right to speak of many of these prices and wages as though they were determined in a competitive market in such a way that to interfere would produce enormous distortions in the economy. Moreover, the notion that all of the European experience is negative is, I submit, a piece of folklore. The British experience does suggest that it is possible for an incomes policy to induce certain restraint—if only because both sides are equally frustrated. It is not accidental that every Western democratic capitalist country has attempted some kind of incomes policy.

Conclusion: This incomes policy is not the part of the program that turns me on, and it will not do any good in the absence of monetary and fiscal restraints. And I would emphasize that we intend to mount a comprehensive attack on structural defects in the economy and on government interventions that inflate costs and prevent competition.

DR. OSWALD: But this is really a controls program put into effect on the wage side without any legal basis, which is not the way such matters should be handled. There should be an appropriate body with sufficient manpower to hear cases. There should be a legal basis for punishing those who do not conform—not just vague threats without legal basis, or attempts to use laws for purposes other than those for which they were designed. If we are going to have controls or guidelines then we should do it right, by law, and equitably.

DR. KAHN: When a lawyer tells me I am not following due process, I tend to hold onto my wallet. When an economist tells me the same thing, I hold onto my checkbook too. Now I am not an expert on the law, but our lawyers tell us it is perfectly reasonable for the government to use its regulatory authority to prevent the passing on of inordinate wage or cost increases.

DR. GREENSPAN: I would like to go back to some fundamental questions that Dr. Kahn raised. I agree that the Teamsters do not strike one as a union characterized by extreme competition, but I would not therefore conclude that the solution to the problem is guidelines. There are obviously far more effective and long-run solutions—such as deregulating the truckers—which, working through the market mechanism, would have a surprising impact on the Teamsters themselves.

The question whether the European experience is valid is an extremely difficult one. I tend to agree with Dr. Kosters but grant that it is extraordinarily hard to read some of the evidence. Certainly the hypothesis that guidelines

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work is extremely difficult—I personally believe, impossible—to prove, though it is also difficult to prove the opposite.

The reason democratic societies attempt controls when confronted with inflation is that the approach is perceived to create short-term political benefits—and in certain instances it does. President Nixon's freeze in August 1971 did in fact slow the rate of inflation. But the problem is that while there are short-term benefits, there are invariably longer-term costs. One of the difficulties in societies like ours is that politicians tend to overemphasize short-term benefits without fully comprehending the long-term costs.

A major problem with controls—mandatory or voluntary—is that they give the illusion of success while creating difficulties far greater than we can imagine. One of the more recent examples—in this case from the Nixon years—lies in energy price regulation and the difficulties that have emerged with unleaded gasoline. Controls tend to create huge bureaucracies, which for the most part shuffle paper and cannot be demonstrated to have significant impact on the overall price or wage level. In the longer run, because they thwart productivity, because they generate imbalances in the system, they tend to produce rather than fight inflation.

DR. KOSTERS: We should recognize here that wage and price controls, whether voluntary or mandatory, are only one of the many policies that are being carried out. This, of course, is what makes it difficult to assess the impact of any given program at any time.

Take, for example, the British case. It is true that inflation came down while the policy was in force, but it is also true that there was a good deal of fiscal belt-tightening already going on when the policy was put in force. The fact that other policies are being carried out at the same time as wage and price controls creates one of the main dangers of such a program.

Back in 1971 and 1972 it was often said that the controls then in force helped to make possible a more vigorous expansion than we could otherwise have had. And today, it is often said that we need to make a choice between voluntary controls (or, if they are not successful, perhaps mandatory controls) and recession. When one is talking about that kind of choice, one is talking about more stimulus to the economy with the controls in force than would otherwise be considered prudent. That seems like a formula for more inflation rather than less, from everything we know.

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—Marvin H. Kosters

DR. KAHN: There is no question that when the mandatory controls were imposed in August 1971 in anticipation of an election fifteen months ahead—and, of course, I am not impugning the motives of the Republicans any more than those of the Democrats, who would have done the same thing if they had been in power—

MR. DALY: Nor suggesting that history will repeat itself?

DR. KAHN: Precisely.

The imposition of controls at that time was obviously part of a deliberate attempt to inflate the economy, and for obvious reasons. We were making unsatisfactory progress in reducing unemployment and it was thought that, if controls were imposed, we could have massive monetary expansion and budgetary looseness. But that is clearly not the same thing as imposing far looser, far less massive, less bureaucratically enforced controls—with a bureaucracy not of 6,500 people but of only 100—and doing so in the context of a determination to reduce federal spending and thus the size of the deficit, to increase interest rates, and to reduce the rate of growth in the money supply.

I concede that our guidelines still are, to some extent, restrictions and controls. But we are talking now about controls in a context where macroeconomic restraint is being followed. The guidelines simply represent an unwillingness on the part of the government (and I think the country) to rely exclusively on a jamming on of the monetary and fiscal brakes. The distortions are far less likely to be serious than they were in 1971–73—though I would not

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welcome permanent controls with any more enthusiasm than Dr. Greenspan does.

DR. KOSTERS: It is important to recognize that from our current perspective, it looks as though there was a deliberate attempt to overstimulate the economy back in 1971 and 1972, and as though it was widely recognized at the time that the economy was being overstimulated. I don't think that was the case. If we look at what was said then, we will find a broad consensus among economists that it was important to stimulate the economy, and not dangerous. I am not referring to late 1972 but to 1971, when the controls were imposed. Whether we turn out to be in similar difficulty a year from now will depend largely on what happens to monetary and fiscal policy in the meantime, just as it did then.

DR. OSWALD: But it is important to look at the difference between 1971 and now. In 1971, the inflation rate was a little over 4 percent; now it is over 9½ percent. In 1971, food prices were relatively stable; now they are going up at a 12½ percent rate—and they are a major factor in the consumer price index. In 1971, energy costs had not yet been pushed sky-high by the OPEC cartel; now they too are going up rapidly and are expected to continue to do so for the next few years. Moreover, medical care costs were rising rapidly in 1971 and they still are. Finally, interest rates have been going up substantially, which has been pushing up the cost of housing.

Monetary and fiscal policy will not address the problems of food price increases, will not directly address sectoral problems. To say that cosmetic wage-price guidelines, along with a strong monetary and fiscal program, will take care of our inflation is to neglect the pressures in different segments of the economy, pressures that are pushing up the price level much more rapidly than was the case in 1971.

DR. GREENSPAN: What basically concerns me, Dr. Oswald, is that President Carter's program will beget yours. The reason I say this is that I think it is unrealistic to presume that we can have a stable, unchanging guidelines program. We are already beginning to see the tendency of the Council on Wage and Price Stability staff to make the mistake of answering the questions being put to them. What that does is to create an ever-increasing body of decisions, or quasi-judicial regulations. One decision creates another and, before we know it, we will have—maybe not 6,500 bureaucrats, but certainly many more than 100. Moreover, a program of guidelines or standards must of necessity be politically comprehensible, but even a skillfully crafted effort can at best scarcely pick up more than 95 percent of the possible types of wage and price decisions being made. If we try to bring the last 5 percent under the guidelines, we will get an extraordinarily burgeoning system which will be made mandatory because it will have all the characteristics of mandatory controls except the authorizing legislation.

In fact, I think the present approach is already beginning to unwind. As time passes, we will be inexorably pushed towards more and more regulation. Ultimately, I fear, we will get what Dr. Oswald wants. And what he wants will not be good for the country.

DR. KAHN: On the question of energy prices and food prices, I agree that the solution is not mandatory price control or any kind of price control. To the extent that prices would be set below some sort of equilibrium point, we would simply be concealing from consumers what the real marginal costs of those supplies are—and that way lies disaster.

The part of the program that I find attractive is—and, again, I recognize the difference between promise and performance—that we are attempting to look systematically at those sectors that have been preponderantly responsible for the increase in the cost of living. We are attempting to identify the restrictions on competition, the insanities of methods of organization (such as the way we pay for medical care), the interferences with the free market (such as we have in agricultural policy or trucking regulation), the building codes and land use restrictions and inadequate taxes on land held out of use. There are millions of things that can be done. But the thing that should not be done is to try to use rigid controls to hold down the price of oil when the incremental cost to the U.S. economy is $14 a barrel.

DR. KOSTERS: Dr. Kahn has indicated it is important to let the market work its way with oil. On the other hand, he has indicated he thinks there would not be a shortage of Teamsters if

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their wage increases were held down somewhat. Now that, it seems to me, poses a problem for Dr. Oswald. A case can be made for saying that there will be a lot of business firms with an incentive to enforce the 7 percent wage guideline, whereas it will be difficult to determine just how much compliance there is with a voluntary price guideline (which is an enormously complicated thing to audit or even to compute). Thus, if one feared the possibility that the wage guidelines might bite harder than the price guidelines, would he not favor a reduction in the recent increases in aggregate demand so as to avoid the prospect of wages being held down, while prices floated upward in response to fairly buoyant demand?

DR. OSWALD: That assumes our recent price increases have been purely the result of excess demand, and no one is saying that today. There may be one or two small sectors in the economy where there is excess demand—cement, for example—but, by and large, we have continuing high unemployment, nearly 6 percent, and a large amount of unused industrial capacity. Demand is not excessive compared to what we can produce. Therefore, a reduction in aggregate demand will not ensure reductions in prices, and it might compound the problem. We might have a continuation of very high inflation at the same time that monetary and fiscal policy are pushing the economy towards recession.

MR. DALY: Dr. Kahn, how will Congress respond to the request for enabling legislation for real wage insurance?

DR. KAHN: That plan was formulated before I came on the scene, but I am informed there were numerous soundings with the Congress and that the response was generally favorable. There have, of course, been some criticisms.

I find real wage insurance a very attractive and imaginative idea. The general notion is that workers who settle for wage increases within the 7 percent standard—making an act of faith that they will not suffer from a failure of others to follow—will be insulated against an increase in the cost of living beyond 7 percent by receiving a tax rebate for the difference between the 7 percent and the increase in the cost of living. This is like the tax incentive plans that are designed to cause people to behave in a socially responsible way in areas not subject to perfect competition.

DR. OSWALD: Even after that description, I am still not sure what real wage insurance is. But I like the response of the person at the Council on Wage and Price Stability who, in essence, said, "Don't bet on it, because it has to go to Congress." The plan has also been described by the worker who said, "What have I gained by taking the money from one pocket and putting it into another?" In other words, he pays for it in taxes and gets it back in taxes.

DR. KAHN: If he gets a wage increase above 7 percent, he pays a tax on the increment as well. I do not see any inequity in making the real wage insurance subject to taxes—though it has not yet been decided to do that.

MR. DALY: Might Congress consider the plan seriously if a limit were put on the amount of the tax rebate?

DR. KAHN: Obviously, the fiscal exposure is worrisome. However, we have this simple litany: the more people that sign up, the greater the budgetary exposure, but also the less the likelihood of having to pay, because so many will have settled at 7 percent. If that works out, the fiscal exposure is reduced, and vice versa.

DR. KOSTERS: Superficially, real wage insurance has a nice ring to it. But the more one looks at it, the worse it appears. One reason is that wage increases occur every year in a wide variety of sizes. In 1977, for example, first-year wage increases for major unions averaged about 8 percent, but about 30 percent of the workers getting increases under those agreements got increases of less than 7 percent and about 20 percent got increases of more than 9 percent. The 30 percent would benefit from real wage insurance, but those who received more than 7 percent would have little interest in a program that allowed them only to keep up with inflation, because they could probably do better in their own bargaining. So the program would have haphazard distributional consequences.

The program would also be extremely difficult to carry out because of the kind of information that would be needed. What we now report on our income tax returns is, in general,

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earnings. But, to make the appropriate calculation here, we would need the wage and the time spent at work, so that we could assess wage rate changes. We would also need all the fringe benefits and other forms of nonmoney income —assuming this were included in the standard. If it was not, then of course there would be an incentive to move away from wages toward fringes. Resolutions to all these complex problems would have to be spelled out in sufficient detail so that IRS auditors could look at the situation the way they now look at individual income tax returns.

DR. KAHN: The Treasury experts assure us there would be no significant difficulty in employers' reporting on W-2 forms what has happened, ex post, to average hourly pay (including fringe benefits) from third quarter to third quarter, let's say, after removing overtime. On new contracts, it would be necessary to have some sort of a certification by the Council on Wage and Price Stability. But I had understood that Dr. Kosters, for example, was for years in the business of certifying whether a settlement fell within certain guidelines. This is not a debating point. I am only suggesting he may be exaggerating the difficulties.

DR. GREENSPAN: I think the Treasury experts are oversimplifying. What they are basically saying is that the system would use an average earnings figure. The difficulty is that it would be hard to know whether one was looking at a promotion or a wage increase. And there would be problems of part-time workers and of bonus workers. This has all the earmarks of a tremendously complex program, and what we are seeing is only the tip of an iceberg. I suspect that when the congressional committees hold hearings, these complexities will baffle them.

. . . the [wage] control mechanism of the program reaches down through the smallest employer . . . to every last employee, while on the price side, there is nothing.
—Rudolph Oswald

DR. OSWALD: I just want to add that the control mechanism of the program reaches down through the smallest employer (even those with only one or two employees) to every last employee, while on the price side, there is nothing.

MR. DALY: Dr. Kahn, will you describe how you think the new Regulatory Council is going to work?

DR. KAHN: The Regulatory Council is, of course, the organization of the regulators and, frankly, I am uncertain to what extent one can count on the regulators to reform themselves. The council may play an important role in reconciling conflicting agency approaches. But, from my standpoint, the important body is the Regulatory Analysis Review Group, which is a separate group trying to apply economic standards of cost effectiveness and cost-benefit analysis to major regulations. How effective this scrutiny is will ultimately depend upon the amount of force the President is willing to apply.

MR. DALY: In recent years, we have heard a great deal about monetary policy as a principal and most effective weapon against inflation. Should monetary policy have greater weight than other policies?

DR. GREENSPAN: What we know is that excessive monetary growth is invariably accompanied by inflation, and vice versa. Where we have difficulty, often, is in defining which is cause and which is effect.

In my view, one of the major forces creating our present inflation has been the extraordinary credit expansion of recent years. This has induced major problems for the Federal Reserve Board, requiring it either to accommodate a sharp rise in interest rates or to supply credit to the system—which, essentially, expands money supply in an inflationary way. What the board has done of late—and it does this, I suspect, all the time, irrespective of the rhetoric—has been to compromise.

Money supply is critical, but I would not focus on it as something to be turned on and off, because it, too, is critically determined by other things. Before we can get a grip on money supply growth and, hence, on inflation, we must reduce the economy's aggregate credit requirements—federal borrowing requirements (which come from the budget deficit and from off-budget financing) and private-sector credit requirements (which the federal government

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indirectly imposes on the private sector by mandating safety and environmental standards that businesses cannot meet without borrowing). Also many federal grant programs induce state and local governments to borrow. Finally, the most important thing at this stage is the tremendous expansion in the mortgage market, which has occurred largely as a result of government subsidy, direct and indirect. Unless we can come to grips with these things, the Federal Reserve will not be able to restrain the growth in money supply to noninflationary dimensions without an explosive increase in interest rates.

DR. KAHN: The administration is obviously concerned about the rapidity with which the money supply is increasing and the apparently omnivorous demand for credit, fueled by many of the policies Dr. Greenspan has mentioned. What I have difficulty understanding is why, then, we do not see—as Dr. Oswald points out—evidences of really severe demand pull.

DR. GREENSPAN: The reasons are that, along with this expansion in money supply, we have extremely high degrees of risk and uncertainty within the system, which are inhibiting plant and equipment expenditures, inventory accumulation, and a variety of other things historically associated with an expansion in money supply. If we had lower risk premiums, if we had lower degrees of uncertainty, if we had a more stable environment in which to function, we would be confronted with a major demand-pull situation.

DR. OSWALD: To amplify a bit what Dr. Greenspan said, I think some of the money is being used for corporate mergers, for expanding the new gambling activities in New Jersey and other places—for things that are not productive. What we have may be more a shifting of money than a demand for goods and services. And I am not at all sure that traditional Federal Reserve Board actions reach some of the credit creation that has taken place through the stock markets, through options markets, through futures markets, through all sorts of new means of creating credit. I am also not sure that we are really addressing these problems, except for raising interest rates—which is, moreover, harmful to many people.

DR. KOSTERS: I am surprised at the view that there is no evidence of demand pull. The rate of inflation this year—about 9½ percent compared to 6 or 7 last year—is itself some evidence of demand pull. Recall that prices went up before wages. According to industrial production capacity utilization indexes, the economy is in a situation roughly similar to that in late 1972.

DR. KAHN: That is simply a tautology. What we are trying to explain is why prices go up in an economy with 6 percent unemployment and industrial capacity utilization of something like 85 percent. Another way of saying it is that nobody denies we could stop inflation in its tracks if we were willing to cut the rate of growth in the money supply and tighten federal spending. But that would cause—as far as we can tell—serious unemployment. It is this stagflation dilemma we are trying to explain.

MR. DALY: Now that we have laid a very broad base on the Carter administration's wage and price program, it is time to move to questions and answers.

LAWRENCE ROSENBERG, National Science Foundation: My question is primarily for Professor Kahn. Many of the suggested solutions to inflation are of a longer-term structural nature, particularly the suggestions for making markets more efficient and competitive. Do you see any possibilities for shorter-range targets?

DR. KAHN: The targets will be very short-range. Within the course of a year, I expect definite movement toward deregulation of trucking and more thorough deregulation of the railroads. There will also be active discussions of the extent to which we can have more competition in maritime shipping. In the area of farm policy, while no one should expect a millennium, certainly we can move toward less restrictive ways of maintaining farm income. In the trade area, the President just vetoed cotton textiles protective legislation and the beef quota bill. We are also interested in state regulation of insurance. Do you know that in the states with open filing—which means a greater possibility of price competition—rates for liability and property insurance are markedly lower than in other states? In other words, I expect to pro-

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duce short-term results in those areas where the government subsidizes, protects, and limits competition.

. . . I expect to produce short-term results in those areas where the government subsidizes, protects, and limits competition.
—Alfred E. Kahn

DR. OSWALD: But this is not really a change from what government has always tried to do in the way of affecting the economy. Moreover, I see no reason to anticipate results from these types of efforts in the next twelve months.

DR. KAHN: I am not promising miracles, but we had an airline regulation system for forty years, and we changed it this year. Perhaps people will learn that deregulation is not so bad after all. The airlines can make more money, can bring bargains to travelers, can even reduce fares by 3 percent at a time when the CPI goes up 7 percent.

DR. KOSTERS: These can be constructive actions and helpful in reducing inflation. They would in fact be worthwhile even if inflation were not the immediate problem. But one needs to bear it in mind that the government has always tried to do these things to some extent, as Dr. Oswald said, and that the favorable effects can be swept away quickly by a wave of excess demand.

JOHN KENDRICK, George Washington University: Dr. Oswald, given that labor costs constitute such a large share of total product costs, can we wind down inflation without reducing the rate of increase in average hourly earnings?

DR. OSWALD: Dr. Kendrick has written widely on the possibility of real economic gains from productivity. Now, part of the gains from productivity can be used to slow down inflation.

With respect to Dr. Kahn's emphasis on sectoral problems, there are certain sectoral problems that can be addressed that are not directly wage-related. And, in general, wage changes have not really been pushing prices up in the last three years. Rather what we have seen have been substantial attempts to raise wages to catch up with prices: after all, when someone works, he expects to be able to purchase something with what he worked for.

DR. KAHN: Could I make two points here? First, I have no intention of ascribing blame to one part of the economy or the other, but Dr. Oswald has missed Dr. Kendrick's basic point. If 70 percent of a sales price, or of the gross national product, goes to labor, then there is absolutely no way in which there can be wage increases of 9 or even 7 percent a year, when long-range productivity increases have never been more than 3 percent (and are now more nearly 2 percent), without getting something like 6 percent inflation. It is a matter of simple arithmetic.

Second, on the matter of catch-up: In any given year, at least 50 percent of the population will not have done as well as the other 50 percent. Now, if everyone who has fallen behind has a right to catch up, we have a permanent engine of inflation. Catch-up equals inflation.

DR. KOSTERS: I certainly agree we cannot slow inflation without having a commensurate slowdown in the rate of wage increase. But, as I understand this program, something more is intended. I understood Dr. Kahn to say that the program plans to look at situations where competition in the labor market is less prevalent. Now that makes sense, if we can induce the institutional changes needed to make the situation more competitive. But to use wage controls or some kind of wage-price policy to get a result that we would not get through competition in that industry is to court failure.

DR. KAHN: We were asking before, Where are the signs that excessive aggregate demand is pulling wages up? And we found very few signs in most parts of the economy. It is said, for example, that there is excessive spending for housing, but construction wages have risen much less than the average. My answer is that the basic problem of inflation is a social problem. It is the mark of a society in which people are constantly increasing their income claims—in the wages they demand, in the profit margins they add to their wage costs, in the demands they place on government for tax preferences, or subsidies, or various spending programs. All these add up to more than we can supply at constant prices. Some justify their claims on the

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grounds of catch-up, others on the grounds that they are in industries with above average productivity.

The problem is not easily solvable simply by imposing monetary and fiscal restraints, because that will cause great unemployment. Of course, it would be simple enough to throw 20 million people out of work, and one knows they would then moderate their wage demands. But since we do not want to throw 20 million out of work, we have to do something to induce a general spirit of social discipline—which can come, in my judgment, only by recognizing that we are all like hamsters in a cage, running as fast as we can and staying in the same place. But I think there *is* a general recognition that we all have to moderate our demands if we are to moderate the rate of inflation without causing serious unemployment.

DR. KOSTERS: It seems clear to me that our problem in 1978 has not been one of wages rising faster than prices and, as a result, pushing prices up. It has not been one of workers' saying to themselves, "We've got to catch up, or we've got to do better." Instead, the problem has come from the price side: prices have risen a good deal more than wages this year. So it is difficult to argue that our problem stems from wages pushing themselves up autonomously rather than from demand pushing prices up.

MR. DALY: What part do inflationary expectations play in pushing prices up?

DR. GREENSPAN: Let me combine the answer to that question with a response to Dr. Kahn's very learned comments a few moments ago. Our problem is one for which we have no firm theoretical understanding. For the last six or seven years, we have been endeavoring to establish a theoretical framework for a condition of chronic inflation in a period of less than full utilization of resources. It is not an explanation to say that there are excess demands in the social system because that, translated into economics, is simply demand pull. Our problem is not something we fully understand. When we endeavor to relate wages and prices in our econometric models, we find the models wholly inadequate.

But I would not conclude, therefore, that because we see a relationship between wages and prices, we can somehow treat the symptoms of the problem and presume the issue will be resolved. Whenever we have endeavored to bring down inflation by bringing down wages or to bring down wages by bringing down prices, we have invariably failed. All we can say is that these particular efforts at treating the symptoms have not worked. So, in my view, to call for a particular form of restraint that somehow will simultaneously bring prices and wages down flies in the face of experience.

The idea of inflationary expectations has been seized on as though it explains the phenomenon. But it does not, because the fact that people expect prices to rise further, though it will certainly induce them to take certain actions, will not necessarily induce them to spend more. In fact, our experience is that they will save more, which is actually anti-inflationary.

The problem is tremendously serious. I am very much concerned that we all agree there are fundamental solutions but keep saying that, to reach them, we would have to create 20 million unemployed—which I find rather rhetorical, to say the least. The fact is that we know the solution, but we say it is politically, socially, and otherwise unacceptable. And each year we procrastinate, the problem gets worse, as does the socially and politically unacceptable alternative. At some point, we will have to come to grips with this problem, work hard to resolve it, and stop looking for costless solutions.

DANIEL SKARTVIDT, Fairchild Publications: When the President announced his program, he said the federal government would encourage compliance by not buying from contractors who violated the price guidelines. Subsequently, he urged the nation's mayors—and governors too, I think—to do the same thing. Dr. Kahn, are you moving toward asking consumers to boycott firms that violate the price guidelines?

DR. KAHN: We have not done so explicitly and, though I have not yet reached the point where I can give a full answer, you must recognize that our program is, in very large measure, voluntary. We are determined to fashion a program that will not require any more than 100 people, which means there will have to be a tremendous amount of self-enforcement. The "enforcement agencies" will consist largely of auditors and CPAs employed by companies, par-

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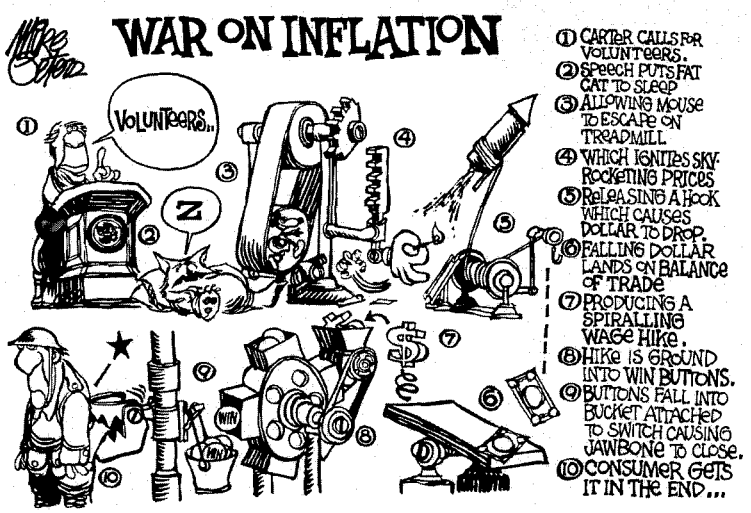
ticularly the big companies. (The latter, I predict, will give us 98 to 100 percent compliance.) We are, as I have observed several times, creating a kind of WPA for CPAs.

DR. OSWALD: That is to expect from consumers something the guidelines do not allow anyone to know. For example, on November 16 the price of *Newsweek* was raised from $1 to $1.25. But there is no way an individual can know whether that violated the guidelines, even though it was a 25 percent increase. The expectation given by the President's message is that the government is concerned, has set guidelines, and will do something. But, while employers will do something on the wage side, nothing will be done on the price side.


WAR ON INFLATION
VOLUNTEERS...
① CARTER CALLS FOR VOLUNTEERS.
② SPEECH PUTS FAT CAT TO SLEEP
③ ALLOWING MOUSE TO ESCAPE ON TREADMILL
④ WHICH IGNITES SKY-ROCKETING PRICES
⑤ RELEASING A HOOK WHICH CAUSES DOLLAR TO DROP.
⑥ FALLING DOLLAR LANDS ON BALANCE OF TRADE
⑦ PRODUCING A SPIRALLING WAGE HIKE.
⑧ HIKE IS GROUND INTO WIN BUTTONS.
⑨ BUTTONS FALL INTO BUCKET ATTACHED TO SWITCH CAUSING JAWBONE TO CLOSE.
⑩ CONSUMER GETS IT IN THE END...

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DR. KAHN: I think that is absurd. The limitations on our enforcement mechanisms apply to both wages and prices. I often hear it stated that profits are not subject to the same sort of standards as wages and prices are. But there is no way in the world one can regulate prices and markups without regulating profits. I concede that our program does not set up an army of auditors all over the country, but that limitation applies to wages and prices equally.

DR. OSWALD: Except that on the wage side, there is an organized group of enforcers—the employers. There is no organized group of consumers.

DR. GREENSPAN: That is not true. The presumption that employers somehow would like to keep wages down, no matter what, misrepresents the way wages are set in the nonunion area. Wages are set not by the benevolence of employers but by the employers' need to keep a good work force. If an employer arbitrarily holds wages below some particular market level, he will find a substantial part of his most productive workers going to his competitors. The view that employers are the wage enforcers badly misreads how the system functions.

DR. KOSTERS: There is an oddity about the way the plan's enforcement mechanism works. It requires the government, when it reviews procurement bids, to take the higher bid if the low-bidding firm has granted a wage increase in excess of the guideline. But it seems to me the government should *not* be encouraging firms that charge high prices and pay small wage increases—and also should not be encouraging consumers to patronize that kind of firm.

WILLIAM BROWN, Ford Motor Company: Dr. Kahn, earlier you mentioned some of the things the Regulatory Council and the Regulatory Analysis Review Group might do about regulatory costs. But neither of these is a major effort. Is there not some initiative government might take to bring these significant costs under control?

DR. KAHN: I think we would all agree, as a general proposition, that the goals of environmental, health, and occupational safety legislation are unexceptionable. But any objective observer would also have to agree that there are extremely large costs here that, in many cases, have not been subjected to the kind of scrutiny for cost-effectiveness that ought rationally to be applied—billions and billions and billions of dollars of such costs. Government, as well as the people at large, *must* recognize that inflation is now our most serious problem, and that we cannot any longer afford to ignore costs in achieving these unexceptionable goals. We must recognize that when we impose costs for this purpose, we are making less food available, less medical care. In short, our resources are limited.

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I regard it as one of my most important jobs to try to introduce this kind of consciousness into government decision-making, and I think the President agrees with me. Whether we succeed is something that only time will tell.

DR. OSWALD: Recently though, some of the discussion on this matter has emphasized costs and said very little about benefits. The fact is that, particularly in the occupational health area, we have been derelict this whole century in not addressing the impact of carcinogens and other substances on the health of workers. To say that we should continue to neglect areas such as this is to disregard a very important element of what life is all about. And that is to live a healthy life, not just a life in which someone is able to make more money or sell a product at a lower price.

DR. KAHN: Dr. Oswald, I feel very strongly about the necessity of looking at benefits as well as costs. You are perfectly right that our society has been derelict in the past in ignoring those values, and this dereliction undoubtedly explains their sudden recognition, which has led to the imposition of these costs. Yet I could cite instances of billions of dollars of totally unnecessary and irrational costs being imposed to achieve the goals you are talking about. There are prescriptive regulations which require that a goal be achieved at 20-50-100 times the cost at which it could be achieved by other means. I share your sentiments, but I will not let you ignore the cost/benefit calculation that must be made.

JOSEPH KIRK, ICF, Incorporated: Would you elaborate, Dr. Greenspan, on the relationship between monetary policy and interest rates in the consumer price index? Second, what changes would you recommend in the administration's monetary policy?

DR. GREENSPAN: The first question implies—in part, quite correctly—that as interest rates rise, so does the official CPI which includes interest rates as one of its components. But I would not, by any means, conclude from this that higher interest rates are a cause of higher inflation. The process by which inflation is reined in will, in the short run, induce an increase in interest rates. But that is a by-product of bringing the monetary aggregates down from inflationary levels of increase to more moderate ones.

On the second question I would say that, theoretically at least, the administration, per se, does not have a monetary policy. It has views, but it is the Federal Reserve that has a monetary policy. And, at this particular stage, the Federal Reserve is in an extremely difficult position, with very little leeway either to lower interest rates or to lower the increase in money supply—and, hence, inflation. The problem comes about because of actions taken in recent years. At this point, the Federal Reserve would not create much in the way of an anti-inflationary policy if it slammed on the monetary brakes before defusing the excessive credit demands that are creating the problem. We must unravel the excess credit demands first and then the board can slow the growth in money supply. It cannot come to grips with inflation simply by trying to restrain the money supply.

BRADLEY GERMAN, Whaly-Eaton News: Dr. Greenspan, you noted that the short-term political attractiveness of wage-price guidelines mask long-term costs. What long-term costs do you anticipate from our current program?

DR. GREENSPAN: Let me give you an example. Recently, a success was claimed when a percentage point was knocked off the freight rate increase that the railroad carriers had initiated. Now, one of the major imperatives of this country is to restore some viability to our railroads, and one way of doing that is to give them—at least for the short run—significant flexibility to raise rates where they have extreme losses, and to put themselves in a position where they can create some profitability without government subsidies. To be sure, a percentage point cut in the announced freight rate will have some small negligible effect in the overall price increase for this particular period. But this short-run benefit could be extremely costly in the long run if it created further deterioration in railroad profitability.

DR. KAHN: I agree with Dr. Greenspan's observation that the apparently intractable problem of inflation is difficult to understand. But it certainly seems to have, as one important component, the fact that wages tend to be based on the behavior of the cost of living in the preced-

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ing period, and prices tend to be based on those wage costs, with an add-on—in some cases a very healthy add-on. And, as another component, there is a tendency to set wages on the basis of an expectation that the rise in the cost of living will continue—which, thus, becomes a self-fulfilling expectation. This comes at a time when we are confronted with some major labor contracts—I recognize this is a very short-run view—that might be settled anywhere in the range of 6 percent to 12 percent.

We cannot ignore the short-run difficulties created even by things I strongly favor—such as deregulating gasoline, or letting the price of crude oil rise to the level imposed by OPEC. There is a loss of real income from increased energy prices, but if everyone in the economy decides he or she must have the same real income as before, we have a built-in inflationary mechanism. There is the same problem, too, with environmental protection costs. Environmental protection is highly desirable in most cases, but we cannot have a cleaner environment and more occupational safety and the same flow of other goods and services as we had before. We have to make choices.

DR. GREENSPAN: I think we can overemphasize the relationship between cost and prices and the cycle that goes on. The amount of actual escalation in wage contracts for the total private nonfarm economy is small. Union employees now number roughly 20 percent of all production workers, and only about half the union employees are under escalator clauses. Certainly there is some evidence that price indexes affect nonunion wages, but the relationship is not clear. And it is by no means obvious that wages are feeding prices, or vice versa.

But this is precisely the theoretical framework on which the guidelines are based. It is assumed that if the process can be slowed, inflation can be reduced. I submit that the evidence for this framework is extremely uncertain. And, in fact, having observed very sophisticated statistical analyses endeavoring to capture this effect so very unsuccessfully, I have little sympathy with this general point of view. I would especially not like to see a major U.S. economic policy resting on what amounts to very thin conceptual reeds.

To be sure, we can always give reasons why we have to take this action or that action, because the short run is important and the long run is far away. But, inexorably, the short run turns into the long run. We have found ourselves, much too often, saddled with the consequences of those short-run imperatives.

But, inexorably, the short run turns into the long run. We have found ourselves, much too often, saddled with the consequences of those short-run imperatives.

—Alan Greenspan

DR. KAHN: Again, I agree with much of what you say. But economists have a tendency to ignore the noses on their faces. The fact is that there was in England an inflation rate in the 20 to 30 percent range, and there was a reaction in which the major unions accepted a guideline or incomes policy limiting wage increases. I am not an expert on the British experience, and I agree that the mere fact that the incomes policy and the reduction in inflation occurred simultaneously does not prove that one caused the other. But when the unions, for three years I believe, reduced their wage demands from over 20 percent to under 10 percent, I find it difficult to believe that this did not have a close relationship to the sharp reduction in the rate of inflation. Am I missing something?

DR. GREENSPAN: How are we, then, to account for the recent turnaround? If there actually was a working de-escalation, would not the British Ford situation be incomprehensible?

DR. KAHN: I do not know the answer to the British Ford situation.

DR. OSWALD: Why limit the discussion to Great Britain? Our neighbors in Canada have had three years of controls and, while there were initial decreases in prices and while wages have been held down, prices have accelerated in the last year—even though, I repeat, there has been no acceleration in wages. There has *not* been a close wage-price relationship in all changes in wages and prices, and we cannot pick one particular situation to justify saying, "By holding down wages, we're going to resolve our inflation problem."

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DR. KAHN: I concede that control of wages is not the only answer to the problem, but neither is it the sole plank in the President's program.

DR. KOSTERS: It is always beguiling to think one can somehow directly influence a wage settlement here or a price increase there. Often, the idea is linked with the notion that if we do that, we will avoid the need for a recession—avoid producing unemployment. But that is a kind of false choice.

The problem of guiding an economy is somewhat like the problem facing the poor golfer. He does not know how far his shots will go or whether they will land on one side of the fairway or the other; and if the fairway has a dogleg and his shot goes out too far, there is a good chance he might have to backtrack. Now, the idea of standards is that they will enable us to move straight to the green, reducing the probability of a recession—or of having to backtrack—when we need to make a turn to reduced demand. But wage and price standards can help very little in that regard. The British experience provides the most plausible example that they might, but, for the most part, they have not worked very well at all.

EDWARD COWAN, *New York Times:* Dr. Kahn, if the problem is a wage-price spiral that is feeding itself and not an excess of general demand, if inflation is a social problem and not an economic problem, how useful will it be to bring down government spending and shrink the deficit?

DR. KAHN: That is a terribly good question, one I have great difficulty answering precisely because I do not see clear-cut signs of excess aggregate demand.

First, there is the burden of financing the federal deficit, to which Dr. Greenspan referred earlier, and which surely plays a role in the tightness of money markets and in the high interest rates. We should reduce the pressure of federal financing demands on money markets.

Second, if the problem of inflation is, in considerable measure, a consequence of people's maintaining aggregate demands on the economy that exceed what the economy can supply at constant prices, then this federal deficit comes to be a symbol. That is, there is a general, rather smug belief in the country at large that it is those bloated bureaucrats who are living on the fat of the land and somehow expanding these programs out of a diabolical desire for self-aggrandizement. I tell these people, who applaud wildly when I say that the President intends to reduce federal spending, that they will probably be the first to complain, because federal programs are one way in which they themselves establish large claims on the economy. In short, there will not be a general belief in the necessity for toning down our demands all around, unless limits are placed on the demands we exert through government spending.

I am not totally satisfied with that answer.

DR. OSWALD: Inflation is a social problem, but many of the proposals for cutbacks in the federal budget would be a social catastrophe. The cutbacks seem to be aimed precisely at those groups that are weakest and need the most help—the people who need jobs, people who need help in housing, people who are on the bottom of the income scale. That is where the impact of cutbacks will be.

DR. KAHN: That is not really fair. I cannot tell where the cutbacks are going to be, and I have sat in on three budget sessions. So how can Dr. Oswald tell?

DR. KOSTERS: It would be a real mistake to regard inflation as mainly a social problem and to think that its solution is to be found in some sort of social policy. If one looks to that explanation, one is overlooking important managerial responsibilities of government. That is, we ought to expect the government to do more than merely set an example. Of course, it should set an example—for instance, by balancing its budget to a greater extent than it has in the past—but it needs to do that not so much to teach individual households to balance their budgets as to reduce the strains in financial markets and, hence, permit a more responsible monetary policy.

MR. DALY: This concludes our discussion. On behalf of AEI, heartfelt thanks to our distinguished panelists and guests. ■

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Squeaky Wheels Get Greased

Wage Controls in Canada

Allan M. Maslove
Gene Swimmer

TAKING A STRONG position against wage and price controls, the Liberal party and Prime Minister Pierre Trudeau were resoundingly successful in Canada's parliamentary election of July 1974. A little more than a year later, on October 13, 1975, Trudeau announced a set of anti-inflation policies that included mandatory wage and price controls. The irony of this about-face was not lost on press or public. In fact, there has been speculation that the reason Trudeau's controls did not begin with a sixty- or ninety-day price and wage freeze—a typical feature of such programs—was that he was trying to differentiate his program from the one the Conservatives had advocated during the previous election campaign.

Imposed by Order in Council effective October 13, 1975, and subsequently by act of Parliament in December, the program was given a three-year life ending December 31, 1978. The order created the Anti-Inflation Board (AIB) to administer the controls, with the board's members being appointed from the private sector by the cabinet, while senior members of the supporting bureaucracy were almost entirely brought in from elsewhere in government service. The bureaucracy of the AIB was organized into two separate branches, one to control wages and one to control prices. This article looks at wage control, examining how the AIB's decisions were arrived at and, from this, drawing conclusions about the way any such agency is likely to act.

Allan Maslove and Gene Swimmer are associate professors of public administration at Carleton University in Ottawa. They are currently working on a larger study of the Canadian anti-inflation program sponsored by the Institute for Research on Public Policy in Montreal.

The Decision Process

The compensation branch of the AIB was given jurisdiction over wage increases in private firms with more than 500 employees, in all construction firms, and in the public sector. For all wage increases in each of these areas, the employer was required to provide the board with detailed information on the increase and on past wages, so that the board could calculate the wage guideline appropriate to the particular employee unit involved. (A couple of definitions here: "wage increase" means all increases in compensation, including fringe benefits; "employee unit" refers to both union and nonunion groups; and "wage increase" includes increases resulting from both collective bargaining and employer actions.)

For guidance in their negotiations, employers or employees could ask the board to calculate their permissible increase in advance or, since the guideline formula was fairly straightforward, they could calculate it themselves. As prescribed, the guideline was the sum of (1) a basic cost-of-living component of 8 percent for the first year of the program, 6 percent for the second year, and 4 percent for the third, (2) a

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national productivity factor of 2 percent, and (3) an experience adjustment factor of minus 2 to plus 2 percent, according to the employee unit's compensation history as related to the consumer price index over the previous two years.

When a wage increase was submitted to the AIB for approval, an officer in the compensation branch would compare the percentage increase negotiated to what would be allowed by the guideline. If the increase fell within the guideline, no action could be taken. If not, the officer examining the case would look for grounds that might justify special consideration (for example, the need to maintain a historical relationship to the wage rates of comparable employee units). He would then present the case to the board with his recommendation—which, in general, the board would follow (not surprisingly, since, once established, the board was averaging over 200 decisions for each day it met). The approved increase could fall anywhere between the guideline (at the low end) and the negotiated increase (at the high end).

One aspect of the decision process is worth special mention. When a wage increase was within two percentage points of the guideline, the senior bureaucrats of the compensation branch were authorized to determine whether it should be approved or rolled back fully or partially, and the case would be sent to the board for *pro forma* approval only. This procedure raises the questions of differences in decision patterns between cases above the two-percentage-point cutoff (decided by board members, albeit with an examining officer's recommendation) and cases below that cutoff (decided by the senior bureaucrats). We will look at this later on.

After the AIB handed down its decision, the employer or the employee unit, if unsatisfied, could go back to the board, *with additional information*, to ask that the case be reconsidered. (Frequently, employer and employees appealed together, a provision to that effect being written into a number of labor contracts.) The AIB could revise its decision on appeal, and in some of the cases we have looked at, decisions were revised. (A second appeal procedure, involving an independent officer called the administrator and empowered to adjust the board's decision, is beyond the scope of this article.)

These procedures seem to have been designed for an environment in which wage increases were likely to exceed the guidelines—the intention being to placate labor. When the program was put in effect, the Canadian Labour Congress (an umbrella federation like the AFL-CIO) advised its member unions to act as though the AIB did not exist and deal with possible AIB rollbacks at a later date. And there was something of a consensus on the subject. The Ontario Labour Relations Board ruled in fact that an employer who refused to discuss a wage increase in excess of the guidelines was not bargaining in good faith (there is no National Labor Relations Board in Canada, but Ontario is Canada's largest and most industrialized province). And even employers preferred to offer settlements above guideline levels in situations, for example, where the choice was between exceeding the guidelines and being unable to hire workers.

What Theory Tells Us

What factors can be expected to determine to what degree a wage increase above the guidelines would be allowed to stand?

A growing body of literature dealing with decision-making in central policy and regulatory bureaus provides our lead for answering this question. This literature concludes that the chief bureaucratic goals are power, prestige, and survival. For example, Keith Acheson and John Chant have identified self-preservation and prestige as the main objectives at central banks, with such other goals as minimizing conflict and ensuring room for action being secondary. Milton Russell and Robert Shelton have found that regulatory agency officials (both board members and staff) are influenced by concern for survival and their post-agency futures, for doing the right thing, and for their reputations with their peers. Albert Breton has suggested that fiscal authorities want to maximize power and minimize risk of confrontation. These conclusions may be adapted to explain the behavior of the AIB, if we keep two points in mind. First, the AIB was new in 1975 and still relatively new in 1978, and it was administering a policy that aroused considerable uncertainty and public skepticism. Second, the AIB was limited to a three-year life, so that no bureaucrat could make a career of it.

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We might thus expect board members and senior bureaucrats to have had relatively short time horizons compared to their counterparts at ongoing regulatory bureaus—and, given their backgrounds, we might also expect them to have been concerned with their *post*-AIB futures and their reputations with their peers. In addition, we would expect the main objective of the AIB early in its life to be winning acceptance and credibility as a legitimate instrument of the government's overall anti-inflation policy, both with the rest of the bureaucracy and with the general public. These operational objectives might be realized in two ways: first, by making the AIB appear effective in curbing the rate of inflation (for the compensation arm, this would mean lowering negotiated wage settlements) and, second, by making sure the AIB avoided alienating the affected groups to an extent that would lead to public discontent and demands for changes in its mandate (including, at the extreme, prematurely ending it). These objectives could, of course, contradict each other, leaving AIB officials with difficult trade-off decisions.

What Happened in Practice

In this context, let us examine how a number of specific factors affected the AIB's decisions. The basis of our examination is two separate sets of AIB decisions. The first set, 292 cases from March, April, and May 1976, comprises decisions in the AIB's start-up phase—these months being the first in which the board processed a substantial number of cases. The second set, 2,672 cases in roughly equal numbers per month from May 1976 to November 1977, comprises decisions from the AIB's established phase. (These latter results are, in some respects, preliminary because they are drawn from research we are still conducting for the Institute for Research on Public Policy.)

Both sets of decisions include only those cases where the negotiated wage settlement exceeded the guideline. (In our tests, we used multiple linear regression analysis to discover the impact of a specific variable on the approved percentage wage increase, holding the effects of all other variables constant.)

First, we looked to see whether board decisions have been affected by the size of the wage increase submitted to AIB for a ruling. What we expected was that the greater the amount by which the negotiated settlement exceeded the guideline, the greater would be the amount above the guideline the board would approve. In other words, "the more you ask for, the more you get." Compromise solutions of this sort might be expected to emerge, given the need for trade-offs between achieving effective rollbacks and avoiding undue alienation of the groups concerned. This trade-off problem would suggest a desire to avoid extreme positions and, indeed, even a casual look gives strong support to the view that the AIB has tended to "split the difference." For the decisions from the start-up phase, the average (mean) negotiated wage increase was 16.3 percent and the average guideline or permissible wage increase 9.9 percent. Lo and behold! The average approved wage increase was 13.1 percent, exactly halfway between the upper and lower bounds. (Or to put it another way, the mean settlement in excess of the guideline was 6.4 percent and the mean approval in excess of the guideline was 3.2 percent.) For the decisions from the AIB's established phase, the average negotiated settlement was 11.9 percent and the average guideline 8.5 percent. The average approved settlement was 9.7 percent, somewhat below the midpoint of the range but close enough to represent splitting the difference.

. . . the greater the amount by which the negotiated settlement exceeded the guideline, the greater would be the amount above the guideline the board would approve. In other words, "the more you ask for, the more you get". . . . Evidently, "squeaky wheels get greased". . . .

Evidently, "squeaky wheels get greased"—and this, in fact, is the major finding of this part of our study. For every one percentage point negotiated in excess of the guideline (or allowable increase), the AIB, in its start-up period, rewarded the employee unit with about half a percentage point more in its final approved increase (holding other variables constant—the strike index, the guideline, and so

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on). After the board was established, it was a bit more stringent, awarding one-third percentage point for every full percentage point negotiated over the guideline.

Second, we tried to find out whether labor militancy had an effect on AIB compensation decisions. While there are many aspects of labor aggressiveness, we focused on just two, a union's ability to negotiate a settlement in excess of the guidelines and its willingness to go out on strike to protest an AIB decision (such a strike being legal in virtually all cases in virtually all jurisdictions).

What we were interested in here was the degree to which the threat of a strike would affect the AIB's reaction to negotiated settlements that exceeded the guidelines. Note that the behavior could change as the AIB, so to speak, found its feet. In the start-up months, it may well have been that the greater the strike threat, the greater the percentage above the guideline the AIB would approve. That is, the board, when faced with the real prospect of a strike if its decision were viewed unfavorably, would approve a more generous wage increase than it would otherwise, other things being equal. In terms of the board's desire for acceptance and legitimacy, the perceived costs of a decision prompting a strike during the start-up phase could be very high. Presumably as the board's position became more secure, those costs would diminish (so far as the board, if not necessarily the country, was concerned).

To test the likelihood that strike threats would influence board decisions, we constructed a strike index. For nonunion groups, this index took the value *zero* (because unionism is a necessary condition for a strike); for union groups, its value was a sliding one, determined by taking a moving average of industry-wide man-days lost due to strikes and lockouts divided by average employment in the industry for the previous two years. We expected to find a positive relationship between the strike index and the percentage wage increase approved by the AIB, at least in the start-up phase.

The evidence clearly supports our expectation. In March, April, and May 1976, the AIB granted significantly higher approvals to unions in strike-prone industries. According to our estimates, a union group from an industry where days lost due to strikes were at the nationwide mean received three-tenths of a percentage point more in excess of the guideline than an otherwise identical nonunion group. In addition, a union group from a high-strike industry (say, with a strike index one standard deviation above the mean) received almost two-thirds of a percentage point more than an otherwise identical union group from a low-strike industry (say, with a strike index one standard deviation below the mean). These values seem small until we note that the average approval in excess of the guidelines was 3.2 percentage points—and two-thirds of a point is more than 20 percent of 3.2. Somewhat surprisingly perhaps, a weaker but still significant positive relationship existed after the AIB was well established: the comparable union/nonunion differential was under one-tenth of a percentage point, but still evident.

Third, we tested to see if the AIB had tried to gain acceptance by being tough on groups that are more in the public eye. On balance, public employee contracts are more visible than private employee contracts and large labor groups are more visible than small. All other things being equal, we expected the size of the wage increases approved to decrease as the number of workers affected by the decision increased, and we expected lower wage approvals for public employees (federal, provincial, and municipal workers) than for private sector employment. It turns out that, in both samples, the AIB decision was *not* affected by the size of the group covered, but that public employee groups experienced approved wage increases about one-half a percentage point lower than otherwise identical private groups.

Fourth, we looked for the possibility of a time pattern in the AIB's decisions. As any bureau becomes better established and its procedures more ritualized, the amount of discretion its individual officers enjoy diminishes. In addition, there was a "borderline" problem: The AIB may have been hesitant to roll back a contract soon after the beginning of controls (October 13, 1975) if rolling it back meant a large deviation from comparable contracts signed just prior to controls. However, a weaning process should have occurred over time as precontrol wage settlement faded from prominence.

We therefore expected to find fewer exceptions to the guideline and thus lower wage-rate

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approvals as the months went by, again all other things being equal. In fact, those cases decided in May 1976 showed average approved settlements almost one percentage point lower than in otherwise identical cases decided in March 1976. After that, the decision date was not a significant factor.

Fifth, some of the settlements submitted to the AIB were two- or three-year agreements. We expected that, given a choice of which year's wage increase to cut back in a multi-year contract, the AIB would have chosen to come down harder in the first year and less hard thereafter. If this were the case, contract length would be inversely related to wage increases approved for the first year of the contract. In fact, in the start-up phase, two-year contracts had one-third percentage point more trimmed from their first-year wage increase than was trimmed from one-year contracts. This fits with the view that the board would have sought to gain credibility from large rollbacks early in the program and would have placated the union with leniency in the later contract years.

Sixth, as an indirect test of this last possibility, we segregated the multi-year contracts and compared the rollbacks in years one and two. The AIB consistently rolled back the second-year contracts by fewer percentage points than the first. And, as expected, contract lengths did not influence board decisions after the AIB had been in operation for a time.

Seventh, since the guideline wage increase represented the lower bound of the AIB's decisions, we looked to find out whether it were true that the higher the guideline, the higher would be the wage increase approved. And so it was. Throughout the life of the AIB, a one-percentage-point higher guideline translated to seven-tenths of a percentage point higher increase approved by the board.

Eighth, we looked for an effect from the average wage level of the workers in the bargaining unit. At the extremes, there would necessarily have been some effect because the control regulations exempted workers earning less than $3.50 per hour and limited high-paid workers to a $2,400-per-year increase, regardless of the appropriate guideline. Our data do not include cases in which these upper and lower bounds are relevant. In any event, we were more interested in examining intermediate wage contracts to see whether the board had engaged in income redistribution by allowing disproportionately high wage increases to lower-wage workers. The answer is that the board did redistribute income in this fashion, but only slightly (in both samples, the effect was statistically significant but inconsequential).

Last, we tested to see if there were differences in decision-making between the AIB board and the AIB staff, particularly in response to union militancy. As already noted, administrative procedures were such that negotiated wage settlements exceeding the guideline by no more than two percentage points were decided by the senior bureaucrats, while those exceeding the two percentage point level were decided by the board itself. For the start-up phase, in the less-than-two-percentage-point cases, the strike index shows no independent effect on the approved wage increase; but in the more-than-two-percentage-point cases, the index is strongly related to the approved wage increase. These results suggest that it has been the board itself—that is, the political appointees, *not* the bureaucrats—that has reacted to the threat of a strike by being generous to militant unions. Of course, as we noted, the effect of a strike threat on settlements diminished once the board found its feet. Thus our preliminary results indicate that political appointees and bureaucrats responded in similar ways over the longer term.

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Conclusion

Clearly, the AIB's prime objective in its first months of operation was to establish its legitimacy and gain acceptance as an instrument of the government's anti-inflation policy. This is the light in which we should interpret the fact that higher negotiated settlements led to higher approved wage increases ("the more you ask for, the more you get") and that a higher

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strike probability also produced higher approved wage increases. These relationships show a desire to avoid labor dissatisfaction that would come from too-strict rollbacks of negotiated settlements and avert the possibility of strikes in response to AIB rulings, since both of these could have damaged the board's image. But even when the board became more entrenched, it shied away from extreme positions and continued its pattern of splitting the difference or compromising. And it still seemed to be cognizant of strike threats, though measurably less so.

The fact that public sector wages were held down more than private sector wages and that the AIB's rulings were more generous early in its life demonstrates the same kind of behavior. So also does the fact that in the start-up phase, wages were held down more in the first year of multi-year contracts than in the second year or after (and more than wages in one-year contracts).

In general, the Anti-Inflation Board appears to have been following a course of risk-avoidance, consolidating its position as an arm of anti-inflation policy. How might this behavior have affected the groups likely to come under its jurisdiction? Over time, these groups might have learned to predict the board's decisions. Employers and employees might then in fact have bargained with specific AIB-approved wage increases in mind and so might have submitted to the board negotiated settlements that would result in their prior "real" settlement being approved. Of course, the more predictable the board's behavior, the more likely this result—and the consistency of the results with respect to splitting the difference suggests that the board's wage decisions may have indeed been predictable within reasonably narrow limits.

In general, the Anti-Inflation Board appears to have been following a course of risk-avoidance. . . .

What then are the implications of all this for wage regulation in general—and, indeed, for all forms of rate regulation? We believe the behavior of the compensation branch of the AIB provides a model for what will happen in any such regulation. The regulatory body will compromise—will tend to split the difference. Once this behavior comes to be expected, the subjects of the regulation will build it into their strategies. Both unions going before the AIB and public utilities appearing at rate hearings will exaggerate their demands, realizing they will be trimmed by the regulatory board. If boards actually split the difference between what is asked and the status quo, the more that is asked, the more that will be given.

There may be a way out of this problem. Borrowing from the literature on final offer arbitration, we propose that regulatory boards be required either to choose the entire proposed wage increase (or, as the case may be, utility rate increase) or to roll it back entirely to the guideline (or present rate), with no compromises allowed. This would put regulated industries into a self-policing situation. Gratuitously asking for large wage or rate increases far above the guideline would be likely to result in a total rollback. Exceptional cases could still be accommodated but only when the circumstances truly warranted it. In sum, a legislated rule requiring an either/or decision would discourage any regulated group or industry from asking for the moon in the hopes of receiving half of it and would force the regulators to make hard decisions (economic and political) rather than save face by splitting the difference. ■

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Warring Critiques of Regulation

Robert B. Reich

CRITICS OF REGULATION charge that it is both politically unresponsive *and* economically inefficient. While these two criticisms are often voiced in the same breath (for example, some commentators argue that the inefficiencies are due to the agencies' being captured by regulated industries or by a "new class" of policy professionals), the two are in fact quite distinct. Indeed they are based on different theories of what regulation ought to be and how the public good is to be determined. And as the courts, the Congress, and the White House initiate reforms seeking both political responsiveness and economic efficiency, the conflict between the two is beginning to show.

The Political Responsiveness Critique

The underlying premise of the "political responsiveness" critique is that regulatory agencies are or should be in the business of reconciling the diverse and often conflicting demands of competing interest groups. Accordingly, administrative law and procedure should have as their aim the adequate representation of all interests affected by the agency, and agency policy-making should reflect adequate consideration of all these interests.

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The intellectual foundations of this premise lie deep in democratic theory. Not only is it assumed that regulatory decisions will better match the "public interest" if those whose interests are affected participate in them, but the very process of public involvement and scrutiny is deemed to be a public good, encouraging confidence in regulatory fairness and reducing the sense of alienation and helplessness that bureaucracies inspire. Moreover, fundamental principles of fairness dictate that individuals should be represented in decisions that seriously affect their own welfare.

The courts in particular have championed public participation. For example, as early as 1966, the Court of Appeals for the District of Columbia Circuit ruled that, within a license renewal proceeding, the FCC was obligated to permit the intervention of spokesmen for significant segments of the listening public (*Office of Communication of the United Church of Christ* v. *Federal Communications Commission*). The basis for the ruling was that, since consideration of such viewpoints was necessary to ensure a decision responsive to public needs, failure to allow intervention rendered decisions arbitrary and capricious. The court noted that in "recent years, the concept that public participation in decisions which involve the public interest is not only valuable but indispensable has gained increasing support."

Public participation has been further aided by several recent statutes that provide funding for interest groups to be represented in agency

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proceedings. The Federal Trade Commission Improvement Act of 1975 authorizes the FTC to pay attorneys' fees and costs of rulemaking participation to any group representing an interest that "would not otherwise be represented in such a proceeding" and whose representation "is necessary for a fair determination of the rule-making proceeding." A bill that received wide support during the last session of Congress—the Public Participation in Government Proceedings Act (S.2715)—would extend similar provisions to proceedings before most other federal agencies.

As opportunities for participation have been enlarged, administrative decision-making has become more open to public scrutiny. Courts have required, for example, that all relevant information in agency files or consultants' reports be disclosed to all participants for comment, that agency announcements of proposed rulemakings give the agency's view of the issues, and that agency decision-makers generally refrain from communicating in secret with particular claimants. Moreover, Congress, in the 1976 Government in the Sunshine Act, has declared it "the policy of the United States that the public is entitled to the fullest practicable information regarding the decisionmaking processes of the Federal Government." And this act requires that, with limited exceptions, agency decision-making be undertaken in public.

Many proponents of political responsiveness also advocate vigorous congressional oversight of agency proceedings (in the form of "sunset" provisions and the legislative veto). They assume that congressional oversight will make regulatory agencies more sensitive to the public generally and more responsive to the parties directly affected by agency action. One of the leading congressional supporters of this view, Rep. Elliott Levitas (Democrat, Georgia), has said that "by giving the elected Congress the right to veto a rule or regulation, we'll have returned to the people the control over these regulations and at the same time sensitized the bureaucracy." (Others, however, argue that the legislative veto will have the opposite effect, since it will enable powerful interests to affect the regulatory process in secret, behind the closed doors of legislative committees and individual members.)

In its purest form, then, the political responsiveness critique assumes that the regulatory process should mirror the best aspects of the legislative process, in miniature. The idea is that regulatory proceedings are properly a struggle among conflicting interests, reflecting varied intensities of concern about the issue and with the preferred outcome being an accommodation among those affected. (It would thus be unnecessary to quantify values like health or safety, inasmuch as difficult trade-offs involving these values would be reflected in the preferences of all participants.) In short, broad public participation and vigorous legislative oversight should render the regulatory agencies more responsive to the will of the people.

The Economic Impact Critique

The premise of the "economic impact" critique of regulation is quite different. It holds that regulatory agencies are or should be in the business of seeking "efficient" policies which maximize public welfare—to be determined by a systematic assessment of the costs and benefits of regulatory action rather than by the clash of political pressure groups. Costs and benefits are measured by assigning values to goods, services, or "qualities of life" produced or foregone as a result of the proposed regulation. Through this process an "optimum"—or at least a more efficient—policy will emerge.

The intellectual foundations of this premise lie in traditional microeconomic theory, which supplies the idea of allocative efficiency. Under this view regulation is justifiable primarily when it is likely to result in an allocation of goods and services better matched to what people want than the result generated by market forces alone, such as under conditions of natural monopoly or other forms of market failure. But even when allocative efficiency is not the goal of a given regulation, consideration of economic effects can also lead to a more efficient regulation, one that achieves its goal at minimal cost.

Those who make this criticism acknowledge that the income or wealth distribution consequences of a proposed action can and should be considered, and they believe that economic analysis will yield an efficient solution for any desired distribution, or at least reveal the magnitude and direction of the distributional effect. They also contend that values

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which are difficult to quantify, like health or safety, should not be ignored, but they insist that these values be assessed in as much detail as reasonable. And they recognize that any decision based on today's assessment of costs and benefits may itself have an effect on future technology and future tastes. But they argue that this merely shifts the time horizon from the short run to the long, and the necessary analysis from static to dynamic.

In recent years, the Congress has passed approximately forty new laws—on health, education, transportation, housing, the environment, and agriculture—that call for evaluation of the economic impact of regulations proposed under them. Six of these laws specifically authorize funding of, or require that a fixed percentage of the agency program budget be set aside for, these evaluations. Similarly, the White House (both Ford's and Carter's) has actively pursued economic impact analysis. By an executive order of 1977, agencies must subject major regulations to a "regulatory analysis" that contains a succinct statement of the problem requiring federal action, the major ways of dealing with it, analysis of the economic effects of the proposed regulation and of alternative approaches considered, and a justification of the approach selected. These analyses are reviewed by the White House Regulatory Analysis Review Group to ensure that major regulations are justifiable in terms of costs and benefits.

Understandably, the courts have embraced the economic impact critique with reluctance, given that judicial review of the wisdom of particular regulations would intrude directly into agency discretion. Still, with increasing boldness, the courts have deemed evidence "insufficient" or the process of decision-making "arbitrary and capricious" when the agency disregarded important economic effects of its actions. For example, in a 1973 case, the Court of Appeals for the District of Columbia Circuit reviewed a refusal by the administrator of the Environmental Protection Agency to postpone (for one year) the application of certain pollution standards. On reviewing evidence on the costs of the decision for the companies involved and for the economy generally, as well as on the likely ecological benefits to be gained by one year's imposition of the standards, the court ruled that the administrator had not introduced sufficient evidence to support his decision (*International Harvester* v. *Ruckelshaus*).

In two recent cases, the Court of Appeals for the Fifth Circuit overturned two separate safety standards on the grounds that they were not "reasonably necessary" to reduce risks under the relevant statutes (*Aqua Slide 'N' Dive* v. *Consumer Product Safety Commission*, 1978, and *American Petroleum Institute* v. *Occupational Safety and Health Administration*, 1978). In both cases, the court found insufficient evidence that the likely benefits of the standards (one requiring that swimming pool slides be equipped with chain barriers and warning labels, the other that worker exposure to benzene be sharply reduced) justified their probable costs.

Conflicting Processes

The two critiques suggest different decision-making processes. The political responsiveness critique emphasizes participation and accommodation, whereas the economic impact critique emphasizes analysis. Thus, the two suggest markedly different approaches to regulatory objectives, fact-finding, and decision-making.

Objectives. The political responsiveness critique assumes that the objectives to be sought in a particular regulation emerge only from the interactions of divergent participants and are not fully defined in advance. This lack of definition enables each of the participating groups to believe firmly, or say credibly to its clients and constituents, that the regulation serves its own purposes, and it means that the objectives are established after the fact. But assessing the economic impact of regulations requires that objectives be articulated as specifically and narrowly as possible, so that alternative (and less costly) means of attaining them can be considered in advance.

Evidence. The political responsiveness critique assumes that the facts at issue are the articulated preferences of parties likely to be affected by the rule. Politically responsive rulemaking would therefore be likely to entail a substantial amount of anecdotal testimony by individuals (including representatives of groups)

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about their wants and needs. The agency might also consider opinion surveys that purported to measure the preferences of larger groups.

The economic impact critique, however, does not generally concern itself with articulated preferences, except as they are included in some form of general equilibrium analysis. The facts at issue are the potential overall costs and benefits of both the proposed rule and its alternatives. To present such facts, expert analysts, armed with economic models, often would suffice. Regression models would estimate the degree to which various changes produced by the regulation would affect other variables. To be sure, different participants might come armed with different models and might attempt to challenge the data, assumptions, or methods of deduction upon which the models of the other participants are based. But the evidentiary value of these presentations would depend on accuracy in description and prediction. And it would be understood that there was an efficient solution, meaning one that maximized benefits or minimized costs. Questions would turn on whose data and analyses pointed to the more efficient solution.

These two different notions about what is at issue in a given proceeding—whether articulated preferences or economic effects—have caused confusion. In recent hearings on a proposed Federal Trade Commission rule to eliminate certain allegedly unfair provisions from consumer credit contracts, some consumers testified about the hardships the provisions had caused them, and various lenders showed how the rule would make it more costly for them to carry on their businesses. Opinion surveys were introduced, showing how consumer law specialists felt about the rule. Other participants presented their own subjective estimates of the rule's overall economic effects. And others introduced economic models purporting to show how the rule would affect the price and availability of credit (FTC Proposed Trade Regulation Rule on Credit Practices, *Public Record 215-42*, 1978). What then are the grounds for deciding on the rule—that its benefits exceed its costs, or that most people think the contractual provisions at issue are unfair?

Decision-making. How is a decision to be made? Under the political responsiveness critique, the "best" decision would be the one that was most politically acceptable (or least politically objectionable)—to which the greatest number of the various participants ultimately would subscribe most enthusiastically. Thus the decision would tend to reflect a compromise among competing preferences. Once the range of preferences was determined, the agency would act, in effect, as an arbiter or referee. Under the economic impact critique, however, the "best" decision would be the efficient one, the one that maximized benefits for a given cost or minimized costs for a given benefit. Negotiation and compromise would have nothing to do with it, and an efficient solution might be unpopular with many participants.

It is not surprising that—except where costs of regulation have clearly outweighed benefits (as now with airlines)—the decision-making process has tended toward a commingling of the two approaches. Often the agency undertakes what amounts to a compromise among competing estimates of costs and benefits (thereby avoiding an explicit choice about whether the substance of the rule is to reflect political accommodation or cost-benefit analysis). For example, in one industry-wide rate proceeding, the Civil Aeronautics Board was presented with two conflicting estimates of the potential changes in air traffic that would flow from a fare increase then under consideration. The CAB staff offered estimates based on an analysis of air traffic and prices over the previous twenty years. The industry, using an analysis that omitted certain years considered to be unrepresentative, offered a very different estimate. The CAB ultimately accepted neither estimate completely but found it could "form the basis for a reasonable judgment on the issue." Its "reasonable judgment" fell between the two positions (Domestic Passenger Fare Investigation Phase 7, April 9, 1971).

But such commingling of approaches is at best dubiously rational, from the standpoint of both political responsiveness and economic impact. On the one hand, it offers participants no effective opportunity to articulate and attempt to justify their own preferences, to exchange views and negotiate over substance, or to air their concerns in public. Certainly participants are apt to have little sense that positions have been understood and tested in debate, and the public is apt to gain little insight into what is actually at stake. In short, in no real sense will

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the public have participated in the formation of policy.

Nor, on the other hand, does this approach necessarily enable the agency to reach an efficient solution. Compromises among competing estimates are inappropriate means for predicting economic impact. Each party's choice of the data, method, or valuation underlying its analysis is based on certain assumptions about the way the world works. By their very nature, these assumptions normally do not lend themselves to compromise, to "splitting the difference." They are either correct or incorrect; they stand or fall on their own. And the relationship between each set of assumptions and its resulting estimate may be unique. Thus, any compromise among choices of data, methods, or valuations may well be inconsistent with the assumptions of all of them, and therefore lack any support in the real world. The resulting solution likewise would be unrelated to the facts and, therefore, worthless in measuring economic impact.

Conflicting Outcomes

The conflicting processes would be of less consequence if they yielded the same outcome, but they do not. From a strictly theoretical perspective (though it may assume a world more perfect than ours is) there should be no difference in outcome whether the agency emphasizes political responsiveness or conditions its regulations on their economic impact. After all, any regulatory "solution" whose benefits exceed its costs will enable those who gain from it to compensate those who lose (or who receive none of the benefits) and still come out ahead. Whenever such compensation is theoretically possible, the regulation will result in a net social benefit. Thus (again in theory), since actual compensation will cause losers and nongainers to acquiesce in the regulatory change, the mere fact that there is unanimous agreement to a compromise will signal that it is economically efficient.

But both conditions—unanimity and actual compensation—are difficult to arrange. Unanimity is rare, if for no other reason than the fact that those who know their acquiescence is needed will find it in their interest to hold out for better terms from everyone else. Actual compensation is often impossible because benefits are not easily exchangeable: it would be prohibitively expensive to exclude noncontributing beneficiaries of clean air or safe products, or to identify and compensate all those who directly bear the cost (such as employees laid off because their polluting factory has to close).

Not only does the possible reconciliation of the two critiques founder on these theoretical points, but in reality an accommodation or compromise among participants, even if unanimously agreed upon, will bear no necessary resemblance to an economically efficient solution. This is because the access that affected parties have to the regulatory process is not necessarily proportional to their potential stake in the outcome. A large and amorphous group, each of whose members is likely to be affected to a very small extent by the proposed regulation (such as all potential beneficiaries of safer automobiles), will have difficulty organizing itself to participate. While its total stake may be very high, the cost of trying to summon resources from its far-flung and relatively disinterested members may be even higher. Conversely, a small group, each of whose members has a high individual stake in a regulatory outcome (such as a trade association bent on gaining a subsidy or antitrust immunity for its industry), can organize itself with relative ease—notwithstanding the fact that its total stake is lower than that of the larger group. The vigor and extent to which specific interests participate in the regulatory process therefore may have little relation to overall gains or losses from the particular proposal.

It could be argued that by rendering explicit certain advantages and disadvantages of the proposed regulation, economic impact analysis helps alert the larger and less organized group to the importance of proffering its own views. But this argument ignores the fact that the very insistence upon economic impact analysis alters the rules of the game; proffered "views" are no longer assertions of preference for certain outcomes, but predictions about economic effects. The resulting issues—what universe is to be analyzed, what variables are to be included, what values are to be measured—are not the sort of questions around which large and otherwise indifferent interest groups are easily (or, probably, ever) mobilized. Indeed, the analysis is apt to be so complicated

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that many individuals or groups may feel that they lack the necessary expertise to participate.

Finally, even if participation were proportional to stake in the outcome, there is no reason to suppose that agreement by a simple majority of participants will be a proxy for unanimity over the long term. Shifting coalitions help ensure that participants in the minority eventually will become part of a majority coalition (and therefore will be given full consideration in the current bargain) only when majority and minority have the same long-term stake in future regulations. But in reality, participants are unlikely to have the same long-term stake or the same ability to see what the stakes are. While trade associations, large companies, and certain public interest groups established to monitor the agency all are likely to be long-term participants, that is not true of smaller companies and individual citizens who are affected only by a particular proposed rule. Not only do they have less bargaining power over the long term, but they also are less familiar with the process. For these reasons, too, outcomes fashioned in accord with political responsiveness will bear little necessary resemblance to outcomes derived from assessments of economic impact.

The Future of the Two Critiques

The primary institutions that shape the regulatory process—the Congress, the courts, and the White House—will continue to clamor for more political responsiveness, while at the same time (I believe) demanding that agencies take more account of the economic impact of their actions. The inevitable tensions between these two critiques will become more visible as agencies seek to respond in greater measure to both.

Legal technicians can be expected to design certain procedural palliatives in an attempt to reconcile these inconsistencies. Perhaps the regulatory process could be arranged in such a way that economic impact and political preferences are assessed in separate proceedings. The first proceeding, which might be subject to legislative veto, would aim to reach consensus about the nature of the problem to be remedied and about the range of politically acceptable remedies. Once these matters were resolved (in a politically responsive way), the agency would begin a second, more technical, proceeding in which it analyzed the various alternatives for their economic impact. Or the agency might use the initial proceeding to generate various efficient analytic solutions to a perceived problem, each of which was based on a certain set of assumptions about relevant variables, measures, and objectives. The second proceeding would then subject these premises to political scrutiny and select the most acceptable efficient solution.

But such procedural niceties probably would fail. It is naive to assume that ends can so neatly be divorced from means. Every analytic input invariably raises issues of participation (for example, should economic analyses of the actual impact of regulations after promulgation be subject to public notice and comment?); and every move toward political responsiveness raises analytic issues (for example, should the effects of congressional vetoes be subject to cost-benefit analyses?). The underlying tensions between the two critiques cannot so easily be avoided.

Then which critique (if either) will prevail? My guess is that this will depend upon the nature of the interests at stake. Where the benefits of the regulation are apt to be spread widely and thinly over the population while the costs initially fall on a smaller group—as with much environmental, health, and safety regulation—there will be a strong demand for economic impact analysis. This is because those who bear the costs will assume that they cannot look to the political process to guard their interests (after all, that process imposed the costs in the first place); they therefore will demand that all such regulations are at least economically justifiable. Indeed, the White House has focused its recent economic impact reviews exclusively on just such sorts of regulation.

Conversely, where the benefits of the regulation are narrowly focused while the costs are spread more widely and thinly—as with price supports, marketing orders, tariffs, and licensing—the strongest demand will be for political responsiveness. Those who enjoy the benefits will know that they can rely on the political process to guard them. They therefore will insist on participation in the regulatory process, along with congressional oversight, to ensure continued protection of their special interests. And they will successfully avoid analysis of economic effects. ■

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Rulemaking, Bias, and the Dues of Due Process at the FTC

Jeremy Rabkin

MADISON warned us at the birth of the Constitution that "enlightened statesmen will not always be at the helm" even in the prestigious councils of the federal government. But whereas *The Federalist* urged a more broadly competitive politics to compensate for the deficient enlightenment of statesmen, our tendency in this century has been to seek political insurance in the procedural vigilance of judges.

A milestone of sorts in this accelerating trend was reached with the November 3 decision of Judge Gerhard Gesell of the District Court for the District of Columbia, disqualifying the chairman of the Federal Trade Commission from further participation in the commission's consideration of proposed regulations against children's advertising on television. Newspaper accounts of Gesell's ruling in *National Advertisers* v. *FTC* have largely focused on how it may affect the commission's ultimate decision on the controversial "KidVid" rules. But the case is also worthy of attention as an object lesson in the futility of our efforts to reconcile broad regulatory authority with popular government through mere legal formulas.

The case against FTC Chairman Michael Pertschuk had been launched by the Kellogg Company, the Toy Manufacturers of America, and a coalition of groups representing the advertising industry. They complained that Pertschuk would be incapable of providing a "fair and impartial" hearing to their arguments against the proposed restrictions on children's television advertising since he had already shown himself a convinced partisan on the central issues of the controversy. And indeed it was relatively easy for them to demonstrate, from the record of Pertschuk's public speeches on the subject, that the chairman retained something less than an open mind on whether advertising aimed at children constituted the sort of "unfair and deceptive" business practice prohibited by the Federal Trade Commission Act. He had frequently condemned the "exploitation" and "manipulation" of children by "slick" television advertising. He had also repeatedly promised public interest groups that he would see to it that the FTC took action on the matter—rather plainly suggesting more action than a mere *consideration* of the proposed regulations. Pertschuk's public rhetoric identified him with a particular side in the controversy and surely lacked the discretion one would expect of a judge in a pending trial.

What made Judge Gesell's decision so remarkable, though, was that the issue of bias arose in this case in the context of a rulemaking proceeding rather than an adjudication and therefore, one could argue, Pertschuk should never really have been expected to conduct himself like a judge. In fact, it is quite rare for the courts to intervene in an ongoing administrative proceeding even when there is reason to suspect biased judgment, since charges of bias can always be considered by the courts on appeal of the agency's final decision. But Gesell's decision to intervene against bias in a rulemaking proceeding was a genuine novelty, setting a precedent we may have much cause to regret (assuming the decision is not overturned by the court of appeals later this year).

In technical terms, Gesell's decision can still be readily justified. Traditionally, it is true, the due process requirements in administrative law have been concerned with ensuring fair and impartial hearings in the adjudication of charges against individual offenders, where the regulatory commissions have been regarded as acting in a "quasi-judicial" capacity. Rulemaking, though, has traditionally been regarded as much less susceptible to dangerous abuse, because administrative rules, like legislative enactments, apply only prospectively and in gen-

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eral terms; for this reason rulemaking was left relatively unencumbered with procedural safeguards until recent years. But the FTC's authority to issue binding regulations is now governed by the so-called Federal Trade Commission Improvement Act of 1975, more commonly known as the Magnuson-Moss Act. By its terms the FTC's trade regulations can be adopted only on the basis of commission proceedings virtually as formal and elaborate as those already required in adjudications. Judge Gesell thus held that under the statutory requirements of Magnuson-Moss, FTC rulemaking is "neither wholly legislative nor wholly adjudicative" but rather "combines substantial elements of both types of proceeding." And on this basis he ruled that Pertschuk should have observed all the proprieties of an adjudication in his public statements on the children's advertising rulemaking.

The decision in *National Advertisers,* then, can be regarded as a justifiable—though probably not an unavoidable—inference from the unusual procedural requirements of Magnuson-Moss, which in effect dress up rulemaking to look like adjudication and leave it to the courts without further guidance to complete the costume. Thus an evasive Congress may be more to blame for the result than an "imperial judiciary." The decision is, in fact, merely the latest instance of a "judicialization" of rulemaking which has been the joint product of the Congress and the courts (see Antonin Scalia, "Two Wrongs Make a Right: The Judicialization of Standardless Rulemaking" in *Regulation,* July/August 1977).

But the result, at all events, is plainly unfortunate. Given the larger trends in administrative law behind it, it is likely to cast a long shadow quite apart from the immediate implications of the Magnuson-Moss Act for the FTC. Already trucking companies have been encouraged by the ruling to file suit against Chairman Daniel O'Neal of the Interstate Commerce Commission, charging that his public advocacy of trucking deregulation should disqualify him from presiding over ICC hearings on the issue. It may turn out that in practice regulatory commissioners will escape Pertschuk's fate simply by inserting a tactful "alleged" here and there in their public speeches. But, according to former FTC Chairman Calvin Collier, the mere threat of such disqualification suits could have a "substantial chilling effect" on the readiness of commissioners to talk about their activities and concerns in public.

Of course, those who believe that the regulatory commissions are already too political may see nothing to regret in such a result. But it is certainly not clear that removing the regulatory commissions altogether from politics would be desirable, since it is only too clear that politics cannot be altogether removed from regulatory activity. Unlike the courts, which can only judge disputes brought before them by outside parties, the commissions can generally set their own regulatory priorities by deciding which possible violations to pursue and which new areas for rulemaking to explore. They thus tend to be judged more by their effectiveness in coping with publicly perceived problems than by their "impartiality" or procedural fairness. Given limited resources to handle extremely broad mandates, commissioners must continually make difficult judgments about how much the Congress—or the public—expects in different areas, or how much the business community will voluntarily accept, or how much effort and expense can be spared to compel business compliance by enforcement actions. Even the determinations that commissions must reach in formal proceedings are often closer to those considered in legislative debate than in the typical courtroom proceeding, as the present controversy over children's advertising well illustrates: Are children's desires for sugared cereals so influenced by television advertising—or so little beyond the control of parents—that protective action is warranted? And would the benefits of any feasible action really outweigh the attendant social costs (for example, the loss of advertising revenues that might have supported more public affairs broadcasting)?

It is essentially in recognition of the political character of regulatory activity that the practice of addressing trade conventions and other public gatherings has long been an accepted part of the commissioner's job—at the FTC as well as at most of the other regulatory agencies. Often these speeches represent relatively costless efforts to induce compliance with a commission's norms or objectives by "jawboning" or by moral suasion. Or the speeches may be used to test public reaction before the commission commits itself to a controversial new course. On the other hand, com-

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missioners may seek to dramatize certain problems to help build a public constituency that will champion their pleas for higher budgets, new laws, or simply moral support from Congress. Pertschuk's moralistic rhetoric on children's advertising, for example, was undoubtedly motivated in part by his interest in stimulating pressures on Congress to offset the lobbying of broadcasters and other opponents of restrictions on children's advertising.

At the same time, of course, one would not want individual adjudications to be decided on a narrowly political basis. When a commission sits in judgment on a particular company or individual, basic fairness obviously requires that the commissioners keep an open mind until they have heard all the evidence on both sides. And, in fact, elaborate procedures have been devised to ensure such impartiality—for in these adjudications, as Judge Gesell noted, even the appearance of impartiality is important. The question raised most pointedly by *National Advertisers* is whether it is reasonable to ask the same due-process proprieties in administrative rulemaking as in administrative adjudication—to demand as much, that is, when regulatory commissions act in effect as legislators as when they act as judges.

The distinctions involved, it is true, are not quite so clearcut as one might wish. The commission in this instance, for example, might have chosen to proceed by an adjudication of initial charges of "unfair and deceptive" trade practices against only the Kellogg Company or only against the toy manufacturers for their television advertising aimed at children. Since the issues involved would be almost equally broad and equivocal and the judgment rendered might become a controlling precedent, one could argue that such an adjudication would have as much of a legislative character as the present rulemaking. But it still makes more sense to be concerned about the appearance of prejudice when it is exercised only against a particular company or segment of an industry. For years critics of the regulatory commissions have urged them to proceed more often by rulemaking than by adjudication, in the interests of fairness as well as efficiency. But because a general rule immediately affects more interests than any particular adjudication, it is also likely to arouse more political opposition—which is doubtless one reason the commissions have often preferred to proceed by the less provocative route of adjudication. When the commissions agree to proceed by the more explicitly political path of rulemaking, it is more than a little strange for courts to direct (or, in this instance perhaps, for Congress to suggest) that the commissioners conceal the political character of the activity.

It is no accident, though, that Congress and the courts in recent years have begun to require more and more elaborate procedures for administrative rulemaking. Having delegated an extremely broad regulatory authority to the commissions, Congress naturally prefers to think—or at least prefers the public to think—that decisions will be guided by expert determination rather than political judgment. The courts, apparently despairing of adequate congressional oversight, seem to have concluded that more formal rulemaking procedures will ensure better administrative decisions. Strenuous efforts to maintain the appearance of expert impartiality on the part of the commissioners follow, then, from the doubts about their political accountability—for certainly an accountable commission could not be any more impartial than the political authorities to which it was held to account. Indeed the more the commissioners keep up the appearance of sober impartiality the easier it is for Congress to avoid calling them to account—though in fact Congress retains an array of quite adequate mechanisms to do so.

Still, it is rather strange to find a democratic legislature embracing the notion that political or legislative decisions will retain more legitimacy or public confidence if made by institutions as much as possible like courts and made by officials with as much discretion and political isolation as judges. But perhaps it is less surprising to find it endorsed by the courts at a time when judges have displayed so much confidence in the ability of the judicial process to settle highly controversial political issues and highly complex administrative problems. The effort to invest administrative rulemaking with the aura of impartial expertise is far more likely to promote public cynicism about regulatory agencies than public respect for their decisions. One only wonders whether there is more to fear from the likely failure of this effort—or from the slight chance that it will succeed. ■

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Readings
of particular interest

Rent Control and the Decline of Cities

"Controlling Rents, Razing Cities" by Roger Starr, in *The American Spectator*, October 1978, pp. 21-24.

"If no one likes to pay rent, why shouldn't it be regulated by law so that politicians can take credit for the largesse," asks Roger Starr. His answer: "One reason only. It doesn't work." In spite of this, rent control is spreading—from New York, where it has continued since World War II, to Washington, Boston, Newark, even Miami Beach. Legislators who support rent control apparently accept two premises: first, that rent control corrects a monopoly pricing system whose victims are the tenants; and second, that without rent control many apartments of acceptable quality would be priced too high for moderate and low-income families.

Starr, a member of the editorial board of the *New York Times* and formerly head of New York City's housing authority, examines both premises. Speaking to the first, he shows that in New York, for example, the largest single owner of apartment housing is the New York City Housing Authority, which owns less than 10 percent of the city's total, and no private party owns as much as 5 percent. In every American city there are thousands of owners of every description, so that no such monopoly exists.

As for the second premise, the effect of controls (and indeed their objective) "becomes the perpetuation of low rents and unchallengeable tenure for those tenants who happen to be protected"—usually those who move the least often, or never, and who are rarely the families with the most modest incomes. This bias toward immobile tenants results from the fact that rent control systems permit rent increases only with a change of tenancy. Two undesirable effects follow. Because the highest turnover is among those who are poor and must move to find work, or must move because they can no longer pay the rent or because the building has become a financial burden to the owner who is abandoning it, the poor tend to live in apartments where the rent is raised most often. It was discovered in New York that the *top floor* in six-story walk-up tenements had the highest "legal rent ceiling" of all the apartments in the building. Because these apartments were the worst, they had turned over most often, with the rent being raised with each turnover.

The other undesirable effect of the bias toward the tenant-in-residence is a "gross misallocation of housing space," according to Starr. Rent control inhibits moving when important changes in family size occur (either expansion or contraction) because there is such a large economic benefit from staying put. But for the city as a whole, rent control amounts to a vast waste of "*public* space." In effect, these controls create a "tenant monopoly that distorts land value downward or, at best, prevents a municipality from taking advantage of its major economic asset, the value of locations that are in high demand." In Starr's opinion, this misuse of valuable land is an indication of the way rent control serves the people who do not need it, at the poor's expense—"it tends to be a middle-class subsidy."

Focusing again on New York City's experience, Starr notes that a vast sum of money is diverted from the owners of rental property to the tenants, whether or not the latter need the subsidies. In his opinion "a very significant part of the deterioration in the better buildings of New York has been due to rent control," that is, to this loss of rental income. The deterioration in middle-class housing creates a demand for government to produce new housing "for the very people who should have been living in the formerly middle-class apartments." Furthermore, no public official dares publicly criticize rent control or point out the connection between it and housing deterioration. In the larg-

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er context, the attitudes that rent control fosters—"attitudes which support the myth that social benefits cost nothing"—are the attitudes that led to New York's financial disasters. Starr suggests that cities contemplating rent control might get a better idea of its true costs by observing New York City's vast debts.

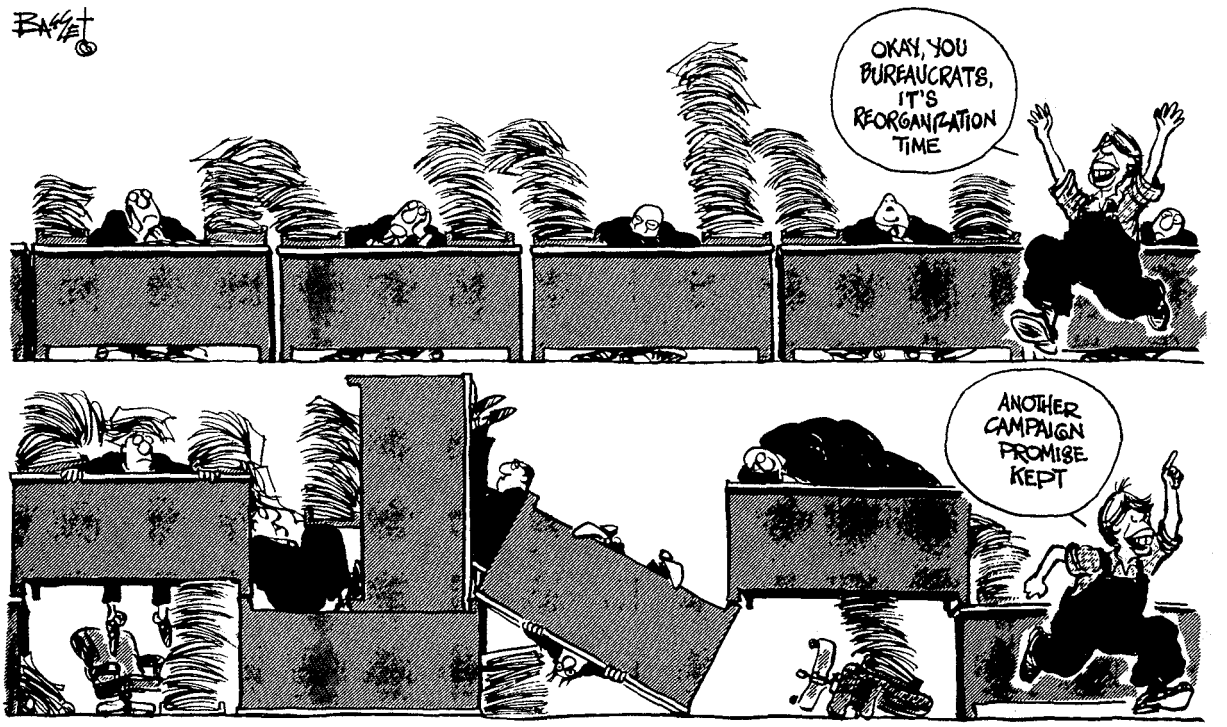
The Real Issue

"Executive Reorganization and Presidential Power" by Barry Karl, in *1977 Supreme Court Review*, ed. Philip Kurland and Gerhard Caspar (Chicago: University of Chicago Press, 1978). pp. 1-37.

Recent discussions of the constitutionality of various reorganization devices (for example, the legislative veto) have tended to obscure the real issue, argues Barry Karl, University of Chicago historian. In his view, that issue is "presidential power versus congressional power in the management of the nation's basic resources," and what is most lacking is a broad historical perspective.

Karl traces the problem of administrative reorganization as a theme in national politics. In the early 1900s, many reformers readily acknowledged that their desire to remove petty politics from national administration implied far-reaching constitutional change, with some urging evolution toward party discipline and cabinet government on the British model, and others looking to the powerful civil service of the German Empire. But, according to Karl, those proposals illuminated without quite solving the central problem: with the federal government playing an ever larger role in managing (or regulating) the use of the nation's economic resources, the power of federal agencies was unavoidably growing to fearful proportions. And, if it was no longer realistic to entrust this potentially immense regulatory power to the necessarily fragmented and partisan Congress, was it, however, safe to entrust so much power to a centralized and self-directed presidency increasingly being freed from legislative restraints in the name of efficiency?

Fears that it was not safe surfaced most dramatically in response to Franklin Roosevelt's reorganization proposals of 1937, which (like his "court-packing" plan of the same period) were denounced as steps on the road to presidential dictatorship. Almost every subsequent administration, in Karl's view, has simply refined the techniques developed by the



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New Dealers for outflanking or overcoming congressional anxieties without directly confronting or redefining the underlying constitutional conflict. These techniques include compromise and cooperation in formulating new policies that could be the basis for more independent executive initiatives later on. The very concept "executive reorganization," Karl maintains, was introduced quite deliberately to avoid confrontation with the presidency itself. "Indeed one could argue that the entire history of the American use of the term 'public administration' is an effort to find a vocabulary capable of removing partisan politics from debates about policy." The same charade has given us terms like "administrative management" and "policy science." However, power "to create and abolish offices, to shift and consolidate functions, to increase or decrease personnel in the management of these functions, is a great power": the power "to limit congressional control over national resources and their distribution, the economic base of political power itself."

Though the Watergate experience has again brought the dangers of an overly powerful presidency to public attention, presidents will undoubtedly continue to struggle for better control over the federal bureaucracy. For if the opponents of FDR's reorganization effort had a very real and powerful claim, so too did its advocates, according to Karl. Given modern conditions, piecemeal congressional oversight of the vast regulatory structure is ineffectual, and lack of central direction and control within the executive branch is intolerable. The tangled connections between agencies and congressional sponsors make it difficult for presidents to translate what they see as their new management or policy mandates into effective action. "Executive management or administrative reorganization, by whatever name, is a response," Karl concludes, "to changes in the basic historical condition of American government."

Profile of the Ethical Drug Industry

The Pharmaceutical Industry, Cotton M. Lindsay, ed. (New York: John Wiley & Sons, 1978), 154 pp.

The 1962 amendments to the 1938 Food, Drug, and Cosmetic Act brought increased regulation to the ethical drug industry, with consequences that are a continuing subject of controversy. This new regulation has accomplished three things: (1) some ineffective drugs have been removed from the market, (2) every new drug undergoes thorough testing before marketing, and (3) claims made for drugs must be supported by sufficient evidence and are now carefully monitored. This collection of studies, which describes the ethical drug industry in this regulatory environment, was edited by economist Cotton M. Lindsay of the University of California at Los Angeles and organized by John H. Wood of Hoffmann-La Roche, Inc.

The history of drug regulation is discussed by Jerome E. Schnee of the Graduate School of Business Administration at Rutgers University, who argues that the 1962 legislation has had unexpected consequences. First, the number of new chemical entities introduced in the United States has sharply dropped and, second, concentration in the drug industry has apparently increased, along with further entrenchment of larger firms. According to Schnee, this is the result of increased drug development costs and of the fact that fewer new drugs appear to "challenge the market position of older drugs." He also discusses the comparative efficacy of premarketing and postmarketing testing of drugs, pointing out that many side effects only show up after widespread use in humans and that the action of certain drugs is "demonstrable only in man." This and other evidence suggests that "premarketing observations can never be an adequate substitute for effective postmarketing surveillance."

The ethical drug industry in the United States has expanded seventeenfold since World War II, is characterized by dynamic competition and a rapid firm turnover, and spends $1 billion annually for research and development. In a chapter describing the industry, Schnee and Erol Caglarcan of Hoffmann-La Roche point out that it also enjoys a higher rate of return on investment than most other industries —allegedly because it charges high prices. Two other explanations are suggested here: (1) the practice of treating research and development as current expense rather than as investment inflates rates of return, and (2) a premium for risk and for growth in pharmaceutical demand produces a higher rate of return.

The book contains chapters on the contributions of the drug industry to improved health

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by David A. Siskind of Hoffmann-La Roche, on marketing by Gilbert A. Harrell of the Graduate School of Business at Michigan State, and on the changing research and development environment by Schnee and Caglarcan. In his chapter, Harrell points out that (according to a 1973 AMA study) although over three-quarters of physicians claim they are influenced by *Physicians' Desk Reference* or by other physicians in prescribing drugs, over half believe industry salesmen have an effect on these decisions.

Schnee and Caglarcan discuss the decline in the rate of new drug introductions. In their view, it has been caused not by industry inefficiency (as industry critics charge) or by the impact of new federal drug regulations (as industry countercharges), but by a more complicated phenomenon: "a widening biological knowledge gap regarding drug knowledge and disease processes in man," which has made advances in drug research more difficult than they were in the past.

In another chapter—on profitability and the ethical drug industry—Walter Campbell of Walter Campbell Associates and Rodney F. Smith of Clark University emphasize the need to study other segments of the health care industry in order to compare their profitability with that of the drug industry. The authors expect to find above-average rates of return on investment "to the extent these other segments produce high-value, relatively low-cost products or services." In the concluding chapter, Campbell describes the emerging health care environment, predicting that the conflict between public and policy objectives, on the one hand, and costs to the taxpayer, on the other, will become greater as new and more expensive procedures are developed in an atmosphere of increased public scrutiny.

Strategies for Regulated Industries

The Regulation Game by Bruce M. Owen and Ronald M. Braeutigam (Cambridge, Mass.: Ballinger Publishing Co., 1978), 271 pp.

This analysis of the "strategic use of the administrative process" supplies the following advice: "No industry offered the opportunity to be regulated should decline it." Among the benefits catalogued here are protection from competition, protection from antitrust attack, some protection from congressional investigation, a greatly reduced risk of bankruptcy, and the virtual guarantee of a "steady stream of adequate profits." Bruce Owen, director of the Center for the Study of Regulation of Private Enterprise at Duke University, and economist Ronald Braeutigam of Northwestern University find the strategic use of the administrative process to be just as important to many businesses as their traditional concerns with prices, entry, and innovation.

Written as a "how-to manual," this book describes the strategic use of litigation (to buy time), of innovation (to forestall an agency decision, for example), and of offering products or services below cost to those favored by government's redistributional policies (in order to protect an entire industry from competition). Given their fundamentally New Deal outlook, many agencies "will not allow competition to affect profits" if they are convinced those profits are necessary to subsidize redistribution. Another important strategy is to get the agency to allow industry self-regulation so that the industry operates as a cartel "under an umbrella of antitrust immunity." Owen and Braeutigam give further advice on how to lobby (by establishing social relationships so that agency decisions come to have human—not merely institutional—impact) and how to co-opt experts and the leading Washington law firms (in order to reduce the threat that the talent will be arrayed against you).

Using six case studies, the authors examine two "tentative hypotheses" about the regulatory process. One hypothesis is that regulated firms and industries operate inside the regulatory environment as they would in the market: they engage in strategic behavior to reach economic objectives. The second is that regulation significantly slows the rate at which "market and technological forces impose changes on individual economic agents." Owen and Braeutigam observe that voters appear to prefer to minimize the risk of the market at some cost in efficiency, viewing a process that gives persons and firms some "legal rights to the status quo" as "fairer" than a laissez faire market system.

The case study material ranges from AT&T's success with the Federal Communications Commission in using strategic innovation, to the success of real estate title insurers in

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using regulation to protect themselves from competition and antitrust attack. Though it supports the two hypotheses, the authors point out that a great deal of empirical research must still be done before the essential validity of these hypotheses can be demonstrated. If research shows that the two hypotheses are true, the next question must be whether the costs are acceptable, or whether there are better means to "achieve economic security and justice." The authors quote Gibbon's comment on the fall of Athenian democracy: "In the end they valued security more than they valued freedom, and they lost both."

Breaking a Cartel

"Price Deregulation in the Brokerage Industry: An Empirical Analysis" by Aharon R. Ofer and Arie Melnick, in *The Bell Journal of Economics*, vol. 9 (Autumn 1978), pp. 633-641.

The New York Stock Exchange was "one of the oldest cartels of modern times." Then on January 23, 1975, the Securities and Exchange Commission adopted Rule 19b-3, prohibiting securities exchanges from fixing brokers' commission rates and bringing competitive pricing to the industry for the first time since 1792. Aharon Ofer of Tel Aviv University and Northwestern University and Arie Melnick of the Israel Institute of Technology and Haifa University view the change as a "rare opportunity" to study the effect of price deregulation in an industry historically protected from price competition. They find that this new negotiated commission system has "led to lower prices and to a pricing structure that more properly reflects the costs of executing different types of transactions."

The exclusive right of national securities exchanges to set commission rates noncompetitively was first modified in 1968 when, as the result of pressure from the SEC and institutional customers, volume discounts were introduced. Other modifications followed, including the introduction of negotiated commissions for transactions over $300,000 and culminating in the 1975 rule.

The authors hypothesize that the following factors ought to explain brokerage commission rates in a competitive market: the size of the transaction, the broker's total assets (a proxy for reliability and service), the quality of the broker's execution, average trading volume in the stock (a measure of how quickly a broker's mistake could be rectified), the price of the stock (a measure of the broker's risk if he makes a mistake), and how soon after deregulation a trade was made (there appeared to be a period of transition when competitive pricing was first initiated). Ofer and Melnick analyze the period from May 1, 1975, to May 1, 1976, to establish the relationship between these factors and commission price per share and to measure the impact of deregulation.

From an examination of 3,718 purchase orders by ten bank trust departments, the authors report that, for transactions under $300,000, competitive commission rates averaged 36 percent lower after price deregulation than before. However, prices did not respond immediately to the new situation, a lag that is attributed to a transition or learning period.

Multiple regression analysis further shows that economies of scale exist in the brokerage industry, that there is "some support to the notion that the commission price will be lower for actively traded stocks," and that large brokers charge higher commissions than small brokers (which may measure a premium for reliability). During the period considered, the trend was one of declining commissions per share traded.

The SEC's abolition of fixed commission rates broke a cartel that began in 1792 when twenty-four brokers agreed "not [to] buy or sell from this date for any person whatever, any kind of public stock at a less rate than one quarter of one percent . . . and [to] give preference to each other. . . ." The result of deregulation is lowered commissions for the public.

Stimulating Price Competition

The Promotion of Price Competition Where Sellers Are Few by Frank Kottke (Lexington, Mass.: D. C. Heath and Company, 1978), 227 pp.

"Given the limitations of human nature," competition is the only means of reconciling the majority of the "conflicts of interest in a modern economy" and, at the same time, promoting full use of its resources to meet consumer demands. This book by Frank Kottke, a

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former Federal Trade Commission economist who is now at Washington State University, describes and evaluates policies the government can use to promote price competition "where the rivals are relatively few." His primary thesis is that the "federal government has adequate powers to obtain price competition in every important market dominated by a disciplined oligopoly. . . ."

The author first evaluates the effectiveness of antitrust enforcement in promoting price competition, concentrating on two areas—that in which industry-wide trade practices have the effect of stifling price competition and that in which a few large firms monopolize an industry's output.

In the first area, Kottke examines the Federal Trade Commission's limited success in ending the use of "delivered pricing"—that is, pricing in which all suppliers of a particular good charge any buyer the same "delivered price" regardless of geographic location. He concludes that, in some instances, "there is significant place for the regulation of trade practices by statute, or by a statute once removed through its interpretation by a regulatory commission." However, for three reasons, this is an impracticable way of securing price competition in the absence of evidence of a conspiracy to suppress price competition. (1) There is difficulty in proving the offense. (2) Even if a court order requiring price competition is obtained, the order is difficult to enforce when both buyers and sellers are opposed to it. And (3) where the questioned practice does not directly and unambiguously suppress price competition, the business sector may cry "unnecessary interference" in economic affairs—a cry to which Congress often responds.

In the second area (where few large firms monopolize an industry's output), the author analyzes the ten occasions where the federal government has broken up a company that controls a large part of the supply of its main product lines. In his view, the effect of these actions on price competition has not been significant. He attributes the poor results largely to the self-restraint of the courts, which guarantees that no plant will be disturbed, that facilities supplying a particular market will be divided among no more than three successor companies, and that the divested firm will have substantial freedom in choosing new rivals. Therefore, "efforts to secure divestiture should be an occasional tactic," not the government's main program to promote competition.

Instead, Kottke argues, government's objective should be to encourage more businesses to enter markets where price competition is lacking. That, after all, is the goal of "trust-busting"—to increase the number of suppliers in a given market. He suggests a number of initiatives. For example, imports should be stimulated in order to increase price competition in U. S. markets. Rather than protecting domestic industry against foreign producers by imposing import duties and "voluntary" quotas, the government should provide adjustment assistance to affected firms (for the purpose of getting into new lines of business) and to displaced workers (for the purpose of new job training). Futhermore, the 1933 Buy American Act, which requires government agencies to buy from U.S. producers even when cheaper imports are available, should be repealed.

Along with stimulating imports, Kottke proposes that the government reduce the barriers that deter market entry for domestic producers. For example, our laws often make it difficult for a firm to enter a new market by acquiring the facilities of another firm, introducing significant changes, and offering customers substantially lower prices. He suggests that "antitrust agencies should be alert to exempt [certain cases] in their enforcement of the federal statute. . . ."

In markets where new entrants are unlikely or would not introduce price competition, the government should stimulate price competition in other ways. It might, for example, become a dealer in certain goods, buying and selling from suppliers in an effort to promote price competition rather than price stability. Or it might temporarily take over failing firms so as to ensure some degree of competition or subsidize groups that propose to avert a firm's liquidation. Thus, since worker-controlled firms have a strong incentive to leave no capacity unused, they might be more receptive to cutting price as a means of competing.

To put the matter briefly, "the government should avail itself of the alternatives most appropriate in each situation to achieve price responsiveness to changes in demand, as well as to changes in cost."

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NHTSA and the Firestone 500

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NHTSA raised the matter, hundreds of internal company documents released after the signing of the recall agreement show precisely the opposite. Thus, a November 1972 memo to a Firestone vice-president warned that "we are in danger of being cut off by Chevrolet because of separation failures," and a September 1975 report that circulated within top management presented an "hypothesis" attributing much of the tire's problem to the failure of an adhesive.

Without such evidence, NHTSA's case for ordering a recall was weaker than it would have been. Thus, NHTSA sought an agreement with Firestone for a voluntary recall that, while less stringent than NHTSA would have liked, would have the advantages of being immune to legal challenge by Firestone and of taking effect immediately. Under the terms of the agreement, the recall is only partial, though it will still cost the company between $100 million and $234 million (depending on how many tires are actually turned in). The estimated 6 million 500s sold before September 1, 1975, are eligible for replacement at half-price with Firestone's current top-of-the-line steel-belted radial (NHTSA has no statutory authority to order recalls of tires sold more than three years ago, but Firestone feared that denying compensation for these tires would anger many consumers). Also, an estimated 7.5 million 500s sold after September 1, 1975, and manufactured before January 1, 1977, are eligible for free replacement. There is to be no recall of some 500s manufactured after May 1, 1976, or of any 500s manufactured after January 1, 1977 (their adjustment rates being, so far, comparable to the norm).

The case has prompted at least two major proposals for strengthening NHTSA regulation. One is to tighten the agency's specific standards, so that tires like the 500 do not reach the market. The other is to give the agency full subpoena power to obtain company information needed to investigate possible defects, so that unsafe products can be identified and recalled as soon as possible. Whether either proposal will be carried out (and what the effects would be if it were) is not yet clear. Meanwhile, millions of old radials are rolling back to Firestone outlets across the nation.

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